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99th Congress
2d Session

SENATE

Report
99-258

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THE 1986 JOINT ECONOMIC REPORT

REPORT

OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ON THE

FEBRUARY 1986 ECONOMIC REPORT OF THE PRESIDENT

together with

ADDITIONAL AND SUPPLEMENTAL VIEWS

March 11 (legislative day, March 10), 1986.—Ordered to be printed

U.S. GOVERNMENT PRINTING OFFICE
58-351 O
WASHINGTON : 1986

58-351 O - 86 - 1

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Mr. Abdnor, from the Joint Economic Committee, submitted the following

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ADDITIONAL AND SUPPLEMENTAL VIEWS

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CHAIRMAN'S INTRODUCTION

David R. Obey, M.C.

This Annual Report is being issued during the year of the 40th anniversary of the Employment Act of 1946. That Act not only established the Joint Economic Committee and the Council of Economic Advisers, but also formally recognized the important role that government must play in promoting growth and employment in the American economy. The Act ratified the key lesson of the New Deal—that our modern economy needed an effective "public economics" to build the foundation necessary for private initiative to lift the economy onto a sustained path of growth and prosperity.

The Employment Act grew out of a widespread fear that the transition from war to peace could bring about a collapse of demand which would shove us once again back into a Great Depression. To help meet this challenge, the Employment Act mandated that the Federal Government use "all practicable means" to "promote maximum employment, production, and purchasing power."

As the data in this Report reveal, the American economy did make a successful transition from World War II, moved forward strongly through the 1960's, but fell off noticeably in the 1970's. The data also demonstrate that current policies have not been able to reverse the striking pattern of uneven growth and persisting problems in our economic structure that have been with us now for more than a decade.

The strong performance of the American economy in the 25 years after World War II was neither an accident nor a matter of purely private initiative. Instead, our enormous growth during this period was the product of good fortune in our economic circumstances combined with good sense in public policy.

We had the good fortune to emerge intact from a war which devastated the economies of the other major nations of the world. But we also had the good sense to craft policies like the Marshall Plan and the Bretton Woods monetary system which would foster growth in the rest of the world and create demand for American products.

We had the good fortune to welcome most of our servicemen back to the civilian economy, but had the good sense to provide them with the skills they needed to be productive members of the new economy. The GI bill and the National Defense Education Act assisted tens of millions of Americans in obtaining an education, and in the process gave the economy the tremendous pool of skilled labor it so urgently needed.

We had the good fortune to see a strong progressive labor movement emerge in the context of the war effort, and the good sense to reinforce positive labor-management relations with laws and practices which protected the rights of labor and promoted wage increases sufficiently large to purchase the output of industry.

We had the good fortune to be blessed with abundant and fertile farmland, and the good sense to develop policies which put that land into ever more productive use.

In general, the policies of the 1950's and 1960's did a good job in meeting the challenges which that era presented. But the 1970's presented us with a set of new challenges which seemed beyond the reach of our old policies.

Inflation was the principal problem of the 1970's. Budget deficits resulting from failure to pay soon enough for the war in Vietnam left us poorly positioned to cope with two oil price shocks and a steep jump in food prices following the failure of the Soviet grain harvest. Faced with significant inflation, the old policies of active demand management appeared helpless. Traditional macroeconomics offered no cure for inflation except deliberate recessions and higher unemployment to cool off the economy. Equipped with only this understanding of the problem, we wound up running macroeconomic policy in reverse, using fiscal and monetary tools not to promote growth, but to induce recession.

Increasingly, the election-year cycle joined the business cycle as a key determinant of economic policy, launching the infamous era of "stop-go economics," with the economy lurching from inflation to credit crunch and back to inflation again. The seemingly intractable problems of the 1970's led to some extraordinary experimentation in public policy. A Republican President, Richard Nixon, expanded the welfare system twice as fast as his Democratic predecessors as the private economy failed to generate sufficient jobs and income for the poor. That same Republican abandoned the gold standard and imposed wage and price controls. Democrats fared no better. Jimmy Carter came to office on a promise to use both fiscal and monetary policy to stimulate growth sufficient to lower the unemployment rate. He left office after totally reversing course, with the Nation adopting an extraordinarily restrictive monetary policy, which resulted in double-digit interest rates *and* high unemployment.

The failure of both Democrats and Republicans to devise effective policies set the stage for a radical departure in the 1980's. Rather than interpreting the 1970's as a period where policy failed to meet the difficult challenges of reality, the Reagan Administration blamed the failures of the decade on policy itself.

In this formulation, the best public economics was no public economics. President Reagan himself said: "Government is not the solution to our problem. Government is our problem."

These views were supported by some apparent new departures in economic theory. Although monetarism and "supply-side" economics contradicted each other in crucial respects, they were fused into the theoretical foundations of "Reaganomics." Monetarism argued that a steady and predictable rate of growth in the money supply would reduce inflation without causing a recession. Supply-side economics argued that a tax cut would liberate a huge reservoir of work, savings, and investment, producing enough growth to finance the tax cut and bring the budget into balance.

In retrospect, inflation was brought under control in the early 1980's, but, contrary to monetarist theory, largely at the price of a recession longer and deeper than any since the 1930's. And the recovery from that recession was purchased with unprecedented increases in both budget and trade deficits, not the huge outpouring of growth and investment predicted by "supply-side" economics.

There is no point, however, in rehashing the 1980 debate about economic policy. It will change no minds. The important question for tomorrow's policy is: Where do we go from here? We must face the fact that, since the mid-1970's, economic performance has continued to be very disappointing, and *neither political party* has developed economic policies that produce sustained levels of strong economic growth without inflation.

The need to find a new set of economic policies has been dramatically intensified by the passage last year of the Gramm-Rudman legislation. Its passage signaled a widespread recognition that the numbers really were not adding up, and that we could no longer paper over problems with mountains of debt and hand the next generation the bills for today's indulgence.

But, while Gramm-Rudman calls a halt to present policy, it does not constitute any sort of solution to the economic challenges ahead. The bill closes off an old avenue for policy, but does not, by itself, open up a new one. That new avenue can only be opened only if all of us—the President, the Congress, both political parties, and the economic leadership of this country—face the fact that the country cannot confront new realities with old political promises.

While Gramm-Rudman certainly was not the route I would have chosen to drive home the need for a new set of policies, I very much welcome the chance it provides to reopen the real debate about economics and economic policy.

An economy must achieve three basic goals, if it is to be judged successful by a democratic society with America's set of values. First, it must produce an adequate and sustained rate of economic growth. Second, it must distribute the benefits of that growth in a way which most citizens believe is fair. Third, it must provide opportunities for all individuals to realize their full human potential.

The principal goal must be economic growth, Growth is essential for making the economy work in both a technical and a human sense. Strong growth makes it easier for an economy to adjust to the technological and competitive changes of modern life by transforming economic life from a zero-sum game into one in which all can win, if we all contribute to help expand the pie.

Strong growth produces rising incomes, and with it the sense of optimism and self-confidence which helps hold a society together. It nurtures a spirit of generosity and caring about those less fortunate, and helps build the social consensus which keeps our society and government working together.

Strong growth is also the only realistic solution to many of our most pressing problems. The third world debt problem can only be resolved through strong growth in the world economy. The threat of protectionism and economic nationalism, which once helped to drive the entire world economy deeper into the Great Depression, will not be averted without solid sustained growth in the industrialized world. And stronger growth at home and abroad is essential to an orderly reduction in the enormous Federal deficit.

Slow growth imposes its greatest burdens on the young, who have not yet made a place for themselves in the economic structure. Some examples:

In 1973, the average 30-year old earned $23,500 in today's dollars. By 1983, the average had dropped to $17,520, And these 30-year olds are not expected to experience the kind of vigorous earnings growth through middle-age that previous generations enjoyed.

When two wages do not seem to bring a family the same standard of living one wage did 15 years ago, when young couples fight to be able to afford their first home, and when 55 percent of children living in single-parent families are being brought up in poverty, it is no wonder that our baby boom generation is accused of thinking more about themselves than their less fortunate neighbors.

But overall growth alone will not get the job done. Successful economies also must manage to distribute the rewards of growth in a manner which citizens believe is fair and just.

The term "fairness" has taken a good deal of abuse recently, with pollsters telling us that most people take it as a code word for "giveways." But fairness is not synonymous with welfare, and we do ourselves a great disservice to dismiss the concept of fairness and justice from our discussions of economic policy.

To me, and to most Americans, a fair economy is one where rewards are distributed on the basis of hard work and where those willing to work can achieve a decent middle-class standard of living. But, today, it is getting harder and harder to earn a middle-class standard of living. Real earnings fell steadily throughout the 1970's, and have not rebounded in the present recovery. The number of prime age individuals who work but are still poor has soared, increasing more than 60 percent since 1978.

At the other end of the income distribution, the rich, who derive much of their income from the ownership of capital, not from work, are expanding their share of national income. According to the Census Bureau, the gap between the richest American families and the poorest has widened in recent years, and now stands at the highest point since they began keeping statistics in 1946.

No one can make me believe that the American economy cannot be efficient without this much inequality. Nations such as Germany and Japan grew faster than we did during the period 1960 to 1983, yet have far less inequality than we do. And our own period of most rapid growth came about when income disparities were significantly less than they are today. In fact, growing inequality undermines the social consensus which is an essential prerequisite to growth. Policies which pursue growth without regard to a fair distribution of both costs and benefits will inevitably generate resistance from those left out and deny the country what it badly needs to plan and prosper—social cohesiveness and continuity of policy.

Finally, a successful economy must meet the test of opportunity. Economic institutions are created to serve the needs of people, not the other way around. Successful economies are those which provide adequate opportunity for all citizens to realize their full potential as human beings, a realization which comes largely through work.

The ability to provide work for all who want it is thus the key test of a society's ability to deliver on the promise of opportunity. But this standard, the United States still has a long way to go. Our inability to deliver on the promise of full employment has greatly complicated our problems in dealing with the poor.

In the past, we have paid attention to those whom the economy left behind through "welfare." And, for many—the sick, the dysfunctional—there is no altnernative except welfare. Yet, we knew then and are even more certain now that, for most, welfare is not a solution. Increasing the ranks of the dependent is not good for either the recipients or for the society.

The programs that worked to build a middle-class America were *opportunity* programs, not *welfare* programs. It was only when we failed to deliver sufficient opportunity that we were forced to expand the ranks of the dependent. We need to renew our commitment to full employment and expanding opportunity, or risk making America an economy that increasingly works only for those with sharp elbows.

Realizing the three goals of growth, fairness, and opportunity will not be an easy task. The world of the 1980's and 1990's will present us with a new and complex set of challenges which must be met in order to reach these objectives.

We now face the difficult challenge of reducing the massive Federal deficit without precipitating a recession or eliminating those government programs which are essential to economic growth. We cannot allow a Gramm-Rudman straight jacket to push us mindlessly into a policy of disinvesting in things that can help make this country grow. And we must recognize that all our economic problems with not disappear with a declining budget deficit.

We will need to meet the challenge of competition in an increasingly integrated world economy, or inevitably face a declining standard of living. We will need to meet the challenge of increasing the growth rate of the world economy, or face a crisis of insufficient demand, increasing protectionism, and unpayable debt. We must meet the challenge of increasing our own rate of productivity growth, improving the quality of our work force, and raising the incomes of our workers. We must find new ways of moving people from welfare to the work world or we will cripple the humanity of welfare recipients and exhaust the patience of the taxpayer.

Meeting these challenges will require the active cooperation of all of our citizens and intelligent, effective partnership between the public and the private sector, and between workers and management. Economics is not just mathematics and models, it is also sociology and politics. Policies which emphasize only market forces and individual self-interest cannot create the sense of social justice or define our true *national* interest in ways which will enable us to devise effective responses to the myriad challenges ahead.

The past five years of experiment have proven that a purely private economics does not provide enough answers by itself. To help get the economy moving again on the path of maximum noninflationary growth, it is time to return to the spirit of creative pragmatism which animated the Employment Act of 1946 and recognized that "public economics" must play an integral role in any modern society.

It is with this sense of pragmatism that the analysis and recommendations in this Report are offered.

The purpose of deficit reduction is to help put the country back on the path of strong and noninflationary growth and increased economic opportunity for all Americans. But if we are going to do so in a way which does not constrain future growth, we must recognize that the budget process cannot be driven solely by an accountant's zeal for neat and orderly ledgers which balance perfectly. It must also be a careful assessment of our society's basic needs and priorities—a balancing of what we must spend now, how we should pay for it, and what kind of legacy we want to leave to future generations.

We don't just need to bring our budget into sensible balance; we need to bring our entire economy into sensible balance. That is why we recommend that all categories of spending should accept spending reductions in reaching a $144 billion deficit target for the coming year. Over the past five years, budget reductions have been maldistributed with the lion's share focused on the portion of the budget that provides investments in the future growth of the economy and the future strength of American families.

The Congressional Budget Office has calculated that, in 1962, the share of our national resources which we devoted to domestic discretionary programs was about 4.2 percent of GNP. That figure rose to a high of 5.8 percent in 1979-1980. Today, it has dropped to 4.1 percent—a lower percentage of GNP than we were providing before the Great Society was ever dreamed of. If we leave the budget on automatic pilot, the share of our national resources which will go to this portion of the budget will drop to 3.7 percent of GNP by 1991; and, if we pass the Administration's proposed budget, it will drop to 2.7 percent of GNP. That is not the way to strengthen America's competitive position in the world, or to meet our needs at home. We need a balanced reduction in spending which requires all categories of spending, including the military, to carry their fair share of the load.

We must also face the fact that, because the President will not accept the kind of reduction in military spending that would be required to reach our deficit reduction targets under Gramm-Rudman, additional revenues will be a necessary part of any realistic deficit reduction package. That doesn't mean that we are calling for increasing individual income tax rates—*we are not*.

We would like to see tax reform move forward. The public clearly does not want to see their taxes raised; but the public does want to see the deficit reduced by rising revenues which are picked up from placing a minimum tax on individuals and corporations which, up to now, have escaped their fair share of taxation. Finally, we need to reenforce the current movement of monetary policy away from targeting monetary aggregates and toward greater concern with growth.

In the area of economic opportunity, we need, in general, to move real interest rates down and move growth up to the levels of the 1950's and 1960's through improved macroeconomic policy. We also need to make a special effort to expand opportunity for younger Americans to buy their first homes and to finance their educations. Therefore, we recommend that we reopen two traditional roads to opportunity by: (1) facilitating the ability of first-time homebuyers to obtain either low down payments or low interest rate mortgage financing; and (2) examining ways to expand educational opportunity by providing higher education grants to students willing to engage in national service in return, and by restructuring student loan programs by gearing repayment schedules to actual student income after graduation.

We need to move from talking about strengthening the family to doing something about it. We need to reduce the empty political rhetoric of support for the work ethic and start converting income maintenance programs to bridges back to productive work, expanding training for the structurally unemployed, and increasing the scope and effectiveness of displaced worker programs.

We need to recognize the reality of the world economy and move from annual economic summit meetings, which produce little more than photo opportunities, to improved macroeconomic coordination with other industrialized countries, a more stable and manageable international exchange rate system, and appropriate debt service relief for several key countries that are important to American economic and political interests.

We need to meet the international competitive challenge that confronts the American economy and its people. While the Administration has concentrated its attention and the nation's resources on meeting the military challenge of the Soviet Union, our trade deficits now threaten to match and overtake our budget deficits. While the Administration narrowly defines national security in military terms, our national economic security grows more uncertain every year as American industries and workers are left alone to compete in the world marketplace.

We need to drop our laissez-faire ideology toward trade and start to coordinate our policies into an effective competitiveness strategy. We need to provide more government investment and incentive for worker development, research and development, and infrastructure modernization. If we fail to increase dramatically our level of productivity and investment, if we continue to lose our edge in commercial technologies, and if our work force is not the best trained in the world, then our standard of living will inevitably decline in this increasingly competitive world.

Forty years after the end of World War II, the United States is confronted with a difficult economic transition and it needs a pragmatic set of policies to help deal with this new reality which we face. This Report provides an outline of what needs to be included in a "public economics" committed to growth.

It is a call for fiscal responsiblity. It is also a call for expanding economic opportunity; it is a call for moving from welfare to work; it is a call to assert and defend our economic position in the world with as much dedication and ferocity as we defend our military and security interests in the world.

Above all, it is a call for realism and compromise. We need to forget about what makes us feel ideologically comfortable and simply ask what works—and then do it.

VICE CHAIRMAN'S INTRODUCTION

James Abdnor, U.S.S.

Economic growth is always desirable, but during the next several years it is vital. The economy has made remarkable gains during the Republican administration. But continued expansion is absolutely necessary for the success of our plans to eliminate the budget deficit, improve the agricultural economy, fight poverty, and expand exports.

The budget situation is critical. We in Congress intend to get Federal spending under control, but in order for this restraint in spending to lead to a balanced budget we need a strong economy between now and 1991, the target year for the elimination of the budget deficit.

In this report, the Republican Members of the Joint Economic Committee call for policies to strengthen, lengthen, and broaden the economic expansion. The common denominator of the policies we recommend—and indeed of the policies that JEC Republicans have espoused for many years—is reliance upon the free enterprise system. Even with governmental programs for which there is a clear justification and need, we believe in applying strict criteria of equity and efficiency.

Our policies to strengthen the economy relate to the need to improve the economy's rate of growth from last year's somewhat mediocre performance. A better 1986 will result, we believe, from continued evidence that we intend to reduce the budget deficit and eliminate it by 1991. Greater stability is required in fiscal policy if businesses and individuals are to respond confidently and in ways that will contribute to economic growth.

In the longer term, the expansion must endure for several more years at least. Among the policies we recommend is growth-oriented tax reform, with strengthened incentives to save and invest. Exports must grow more rapidly; this will require better productivity by our trade-related industries and continued expansion of the world economy. Trade barriers must be eliminated worldwide.

As heartening as the economic expansion is, we must recognize that it has not permeated every sector of the economy, and we must not ignore the plight of the sectors that have not prospered along with the rest of the country.

Agriculture is in terrible shape, as our report demonstrates in some detail. Our policies must come to grips with the farm problem. Not only is the decline of the farm economy a terrible human tragedy, it also has dire implications for the industries whose economic well-being depends upon farm prosperity.

Rural areas, which are lagging far behind the rest of the Nation, have been virtually ignored by Federal policy. We document the problem and suggest some remedies.

The Nation's poverty problem—though diminished in recent years despite claims to the contrary—remains extremely serious. Our anti-poverty strategy must be made more effective, but we recognize that economic growth is the best anti-poverty program.

In summary, the Nation's economic performance of recent years has many bright spots. But improvements can be made. We believe that our views and our policies are right for America at this critical time.

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DEMOCRATIC VIEWS

"STRENGTHENING GROWTH AND OPPORTUNITY IN AMERICA"

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CONCLUSIONS AND RECOMMENDATIONS

To Achieve Maximum Noninflationary Growth

RECOMMENDATION NO. 1

The United States should significantly tigthen its fiscal policy. Reducing the defict for Fiscal Year 1987 to $144 billion is appropriate given current economic conditions. Both the White House and Congress should produce budgets which effectively meet that target.

RECOMMENDATION NO. 2

The President's budget fails to meet the $144 billion target established by Gramm-Rudman. Because a responsible Executive budget request is an essential part of the budget process, the President should resubmit to Congress a budget which achieves the target of $144 billion in deficits for Fiscal Year 1987.

RECOMMENDATION NO. 3

Congress should reject any budget which focuses the lion's share of spending reductions on that portion of the budget which represents investment in the future growth of the economy. That portion of the budget would be cut in half from its 1981 levels under the Fiscal Year 1987 budget submitted by the Administration. Concentrating reductions in this portion of the budget would be damaging to the long-term health and the competitive posture of the American economy. *The Administration and Congress should initiate budget negotiations now to create a responsible budget compromise in which all categories of spending must accept some reduction in pursuit of the goal of deficit reduction.*

RECOMMENDATION NO. 4

Revenues must also be part of any realistic deficit reduction package. We do not favor increasing individual income tax rates and we believe that tax reform should move forward as quickly as possible. At the same time, there is clear need for some additional revenue to produce a responsible budget for the coming fiscal year. Congress and the Administration should examine the broadest possible range of sources to produce the revenues needed for an effective deficit reduction package.

RECOMMENDATION NO. 5

The purpose of deficit reduction is to enable the economy to achieve the maximun rate of noninflationary growth in order to maximize economic opportunity. Achieving this goal requires that the economic effects of deficits be correctly measured. The Administration and Congress should examine current practices in Federal budget accounting to determine whether the nominal budget deficit is the most accurate measure of the effect of the deficit on the economy.

RECOMMENDATION NO. 6

Congress should resist any proposed sale of public assets which is put forward simply as a mechanism for reducing the deficit but which is actually only a bookkeeping device which makes today's books look better by making tomorrow's look worse.

RECOMMENDATION NO. 7 [1]

With fiscal policy oriented toward deficit reduction, the goal of promoting strong economic growth must be central to the making of monetary policy. To achieve this goal, monetary policy needs to move away from exclusive reliance on targets for monetary aggregates and toward targets for real variables such as GNP growth, interest rates, exchange rates, and unemployment. The Administration and Congress should encourage the Federal Reserve to continue its present movement in this direction.

RECOMMENDATION NO. 8 [2]

Achieving strong growth without inflation requires faster productivity growth. Government can help create overall economic conditions for economic advances, including productivity gains, but the private sector will primarily determine our degree of progress on productivity. Corporate management and labor leadership should move toward:

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[1] Senator Proxmire states: "I strongly disagree. This recommendation will push this country back to double-digit inflation or worse. In fact, the Federal Reserve Board followed far too inflationary a monetary policy in 1985. It increased the money supply (M1) by a recklessly excessive 12 percent. This was more than five times the rate of increase in real GNP, and almost twice the rate of increase in nominal GNP. In the long run, such a policy is certain to be inflationary. The Committee's recommendation calls for an even more inflationary monetary policy to neutralize the slowdown effect of Gramm-Rudman fiscal policy. As Chairman Volcker has rightly pointed out, such a monetary policy is unnecessary to bring down interest rates. The Gramm-Rudman reduction in the deficit will do that as the government's rate of increased borrowing diminishes. In fact, a more stumulative monetary policy could raise alarms about a return of inflation and have the perverse result of actually raising interest rates. The problem here is aggravated by the lags involved. The inflationary consequences of 1985 monetary policy will not be felt until 1987, since the monetary policy lag is typically two years or so. If the Fed pours more gasoline on this already smoldering monetary fire, inflation will zoom into the stratosphere."

[2] Senator Proxmire states: "Considering a shorter work week. There has been no change in wage and hour legislation with respect to the eight-hour day and the five-day week for more than 50 years. Meanwhile, there has been a vast increase in productivity. It has been estimated that a statutory change in overtime from time-and-a-half to double time would create at least one million jobs at no cost to taxpayer and only modest cost to employers. A statutory reduction in weekly hours to 35 from the present 40 before overtime pay is triggered would create between five million and seven million jobs. Any improvement in wage and hour legislation would at least temporarily cost some workers a modest reduction in compensation. Some would lose overtime to newly hired employees. Most employers could not be expected to increase hourly pay sufficiently to make up for the shorter number of hours worked. The reduction in weekly hours before overtime is triggered would also tend to increase cost and prices somewhat. It would be, however, a humane and practical way of increasing the number of jobs substantially and reducing unemployment without government expenditures. In effect, it would enact a national policy of sharing jobs. This country followed this policy successfully for some 40 years, from the end of the 19th Century until the middle 1930's. With unemployment on a long-term rising trend for the past 30 years, it may be time to resume a modest application of higher overtime payments and shorter statutory work weeks to reduce unemployment. A happy side effect of this policy would be an increase in leisure time for America's 110 million working people."

(1) Providing increased *employment* security for workers in return for *job* flexibility on the part of the workers.

(2) Providing more opportunities for implementing "gain-sharing" mechanisms, including profit-sharing, employee ownership, and productive-based bonus systems.

(3) Giving workers greater participation in the design and implementation of strategies to strengthen quality control, productivity, and work place problem-solving.

TO EXPAND OPPORTUNITY

RECOMMENDATION NO. 9

The most important thing that government can do to maximize economic opportunity for Americans is manage economic policy to maintain strong, stable growth.

After World War II, skillful management of macroeconomic policy to develop a constructive balance between supply and demand was supplemented with policies which enabled families to take advantage of new oppportunity. Government provided low down payment, low interest mortgages to help families purchase housing. It also rewarded service to the Nation by providing GI bill support for those who wanted to improve their education.

Today, The Administration is gutting housing and education opportunities at a time when housing costs consume a huge fraction of family incomes, when large numbers of young families can neither afford nor qualify for mortgages, and when students leave college with thousands of dollars in debt. To recreate our traditional roads to opportunity for a new generation, the Administration and Congress should:

(1) Achieve a balanced deficit-reduction compromise described in growth recommendation No. 3 to bring interest rates down and move economic growth upward.

(2) Facilitate homeownership by expanding opportunities for first-time homebuyers to obtain either low down payment or low interest rate mortgage financing.

(3) Intensively examine two options to expand educational opportunity: first, providing higher education grants to students willing to engage in several years of national service after graduation, along the lines of the Carnegie Foundation Proposal; and, second, providing a restructuring of student loan programs by gearing repayment totals and schedules to actual student income after graduation. Such a reform would need to be broader in scope than the Administration's limited direct student loan initiative in order to equalize the burden between those fortunate enough to land high-paying jobs and those who earn lower salaries in jobs that often provide a greater degree of public service.

TO STRENGTHEN THE FAMILY AND THE WORK ETHIC

It is not enough to simply talk about strengthening the American family while family incomes have been declining for more then a decade. The best way to strengthen the family is to expand economic opportunity for those families in the most economic trouble.

RECOMMENDATION NO. 10

It should be the basic goal of public income-support programs to move people as quickly as possible from dependency to self-reliance. We must not turn away from those who cannot care for themselves, but, for most, work is a better option than welfare.

RECOMMENDATION NO. 11

Congress and the Administration should make as one of their first priorities the changing of today's static income maintenance programs into more dynamic bridges back to productive work. In the coming year, both the Administration and the Congress should intensively evaluate the innovative experiments of states such as Massachusetts, California, Minnesota, and Wisconsin, and draw from them lessons on how to redirect income-maintenance programs toward expanding opportunities for work and self-reliance.

RECOMMENDATION NO. 12

Congress and the Administration should face squarely the reality that providing more employment opportunities without raising inflation requires that workers develop the skills to be productive in a high-employment economy. Both should recognize that private market forces *alone* will not provide the kind of training needed to overcome structural unemployment. Providing adequate funding for employment and training programs targeted toward the structurally unemployed must be a major responsibility of government.

RECOMMENDATION NO. 13

The Administration and Congress must recognize that effective programs for retraining and reemploying displaced workers are essential if the American economy is to remain dynamic and flexible in the face of both technological change and international competition. Present efforts in this area are inadequate, reaching only a disgracefully low *5 percent* of the eligible workers.

To Meet the Competitive Challenge

RECOMMENDATION NO. 14

We strongly recommend that the Administration make closer coordination of macroeconomic policies a priority goal of the Tokyo summit in May. Lower interest rates in Germany, and faster growth in consumer demand in Japan, will be even more essential for world growth if the United States puts its fiscal house in order.

RECOMMENDATION NO. 15

Misaligned currencies and the overpriced dollar pose serious threats to the world economic system. We commend the Administration for its willingness to cooperate with other countries in short-term interventions designed to bring the dollar back into a more reasonable alignment with other currencies. But long-term solutions will also be needed. Better coordination of macroeconomic policies among major nations is essential to any long-term efforts. If this coordination is achieved, the Administration should also examine:

(1) Establishing "target zones" for major currencies as part of a process of promoting close coordination of national economic policies and reducing speculation in currency markets.

(2) Expanding the role of other currencies as stores of value and intermediaries in world trade.

RECOMMENDATION NO. 16

We urge that the Administration's initiative to promote growth in third-world economies should be pursued on a country-by-country basis, rather than simply imposing the same "supply-side" vision in all countries regardless of local circumstances. The Administration and Congress need to recognize that, in some countries, government has stifled private initiative, but in others, governments are too weak to provide stability to economies dominated by selfish and irresponsible private economic elites.

RECOMMENDATION NO. 17

We welcome the Administration's shift toward growth as the long-term solution to third-world debt problems, but urge the Adminstration to develop proposals for short-term debt relief as well. Failure to develop adquate short-run debt service relief measures runs the risk of repeating the 1982 experience, when unilateral acts of desperation by debtor countries threatened the stability of world financial systems—at home and abroad.

RECOMMENDATION NO. 18

Congess must move swiftly on three fronts to revise our outdated trade laws and to correct the U.S. economic policies which are crippling our trading posture. Congress and the Administration should:

(1) Increase pressure on trading partners to open their markets to American products by reducing both formal and informal barriers to American exports;

(2) Provide faster and more effective mechanisms for reacting to unfair trade practices by countries exporting to the United States; and

(3) Attach effective conditions to those forms of trade relief which are granted to permit "modernization." Such relief must in fact be used to achieve modernization, improved productivity, and increased worker involvement, not blindly shelter firms from foreign competition.

RECOMMENDATION NO. 19

Trade law reform is essential, but we also need to recognize that major portion of our competitiveness problem is "Made in America!" *America's eroded trade posture and indefensible trade deficit are, to a large extent, the direct result of U.S. fiscal policy,* which has placed large segments of American business at an impossible competitive disadvantage. The Administration and the Congress must reach an accord *now* on fiscal and monetary policies that bring the deficit, the dollar, and interest rates down to levels compatible with long-run growth and competitiveness.

RECOMMENDATION NO. 20

The Administration should also take a close look at many of the key recommendations of the President's Commission on Industrial Competitiveness and numerous other major panels which have examined this problem. The Administration and Congress should recognize the naivete of our current laissez-faire attitude toward international competition, and should face up to the competitive challenge by:

(1) Providing government leadership in developing a competitive strategy. In a capitalist society, the first responsibility of corporate executives is to their stockholders. We urge the Administration to recognize that it is unrealistic to expect American corporations pursuing their own economic interest to give sufficient attention to the broader national interest without substantial government leadership.

We urge the Administration to recognize that only government has the breadth of vision and the responsibility under our economic system to develop an effective defense of the *national* economic interest. We therefore strongly recommend that government policies and administrative agencies be reformed and refocused to create an effective competitiveness strategy for the United States.

(2) Making funding for research and development (R&D) a major priority of government. Private firms will inevitably under-invest in both basic and applied research, and government must therefore play an active role in reseach funding if our knowledge base is to expand rapidly enough to stay competitive.

(3) Reducing speculation in our investment markets. Corporate raids and mergers financed with unsustainable amounts of debt are harmful to our ability to compete and must be curbed. We note recent moves by the Federal Reserve to limit one such abuse ("junk bond" merger financing), and urge that far more attention be paid to this issue by the Administration, the Federal Reserve, and the Securities and Exchange Commission.

(4) Investing in productive infrastructure. Over the past five years, we have allowed our infrastructure to deteriorate to the point where the deterioration poses a threat to our future ability to grow and compete. Infrastructure finance is primarily a state and local responsibility, but the Federal Government can play an important role as catalyst in providing support for this form of needed public investment.

(5) Investing in the skills of workers. Competition requires constant retooling of workers' skills, and government should facilitate improved midcareer retraining of workers. One innovative proposal which deserves attention involves the creation of Individual Training Accounts, which could be designed to provide an income-based sliding scale of public and employer contributions of supplement worker contributions in order to make retraining opportunities a

reality for the workers who need them most in a world that will continue to change at a rapid pace.

I. THE AMERICAN ECONOMY: A 40-YEAR PERSPECTIVE

This Report is being issued on the 40th anniversary of the Employment Act of 1946. We believe it is important to review briefly the past 40 years of American economic history to provide some context for present and future debates about the course of economic policy.

The graphs on the following pages tell a disturbing story, one which remains roughly the same from one set of data to the next. On a whole range of key indictors, the American economy performed very well during the first two decades after the war, but fell off noticeably during the decade of the Seventies. And in spite of some recent talk about the economy entering a "new era" of growth, the data suggest that today's policy regime has not reversed the 1970's pattern of unseen growth and persisting problems in our economic structure.

The picture that emerges is of an American economy falling far short of its potential. The cost of that failure is a lower standard of living for the American people and weakened American leadership of the free world.

ECONOMIC GROWTH: HISTORICAL COMPARISONS

The two charts on growth in real GNP show a marked deceleration of the U.S. economy. Over the last five years, GNP, adjusted for inflation, grew at an annual rate of only 2.3 percent. That compares with 2.84 percent during the 1970's and 3.81 percent during the 1960's. Last year, which was relatively good one by recent standards, the economy managed a real growth rate of only 2.3 percent, matching the disappointing average since 1980 and far below the optimistic growth forecasts contained in last year's Economic Report of the President.

Figure 1

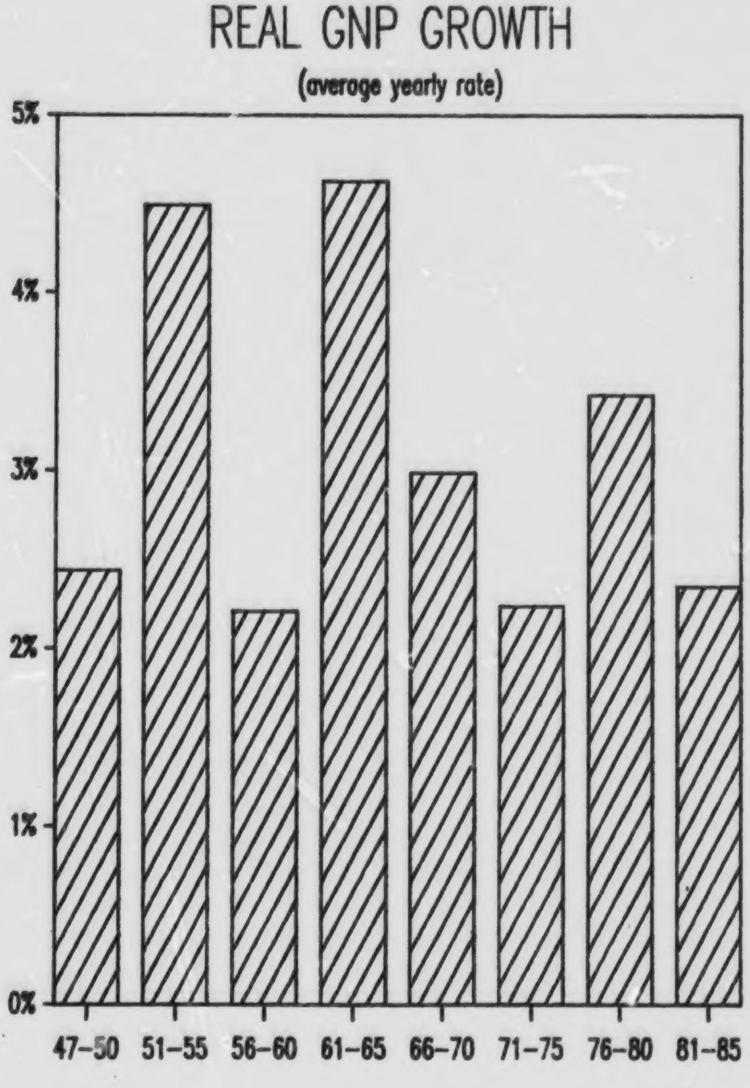
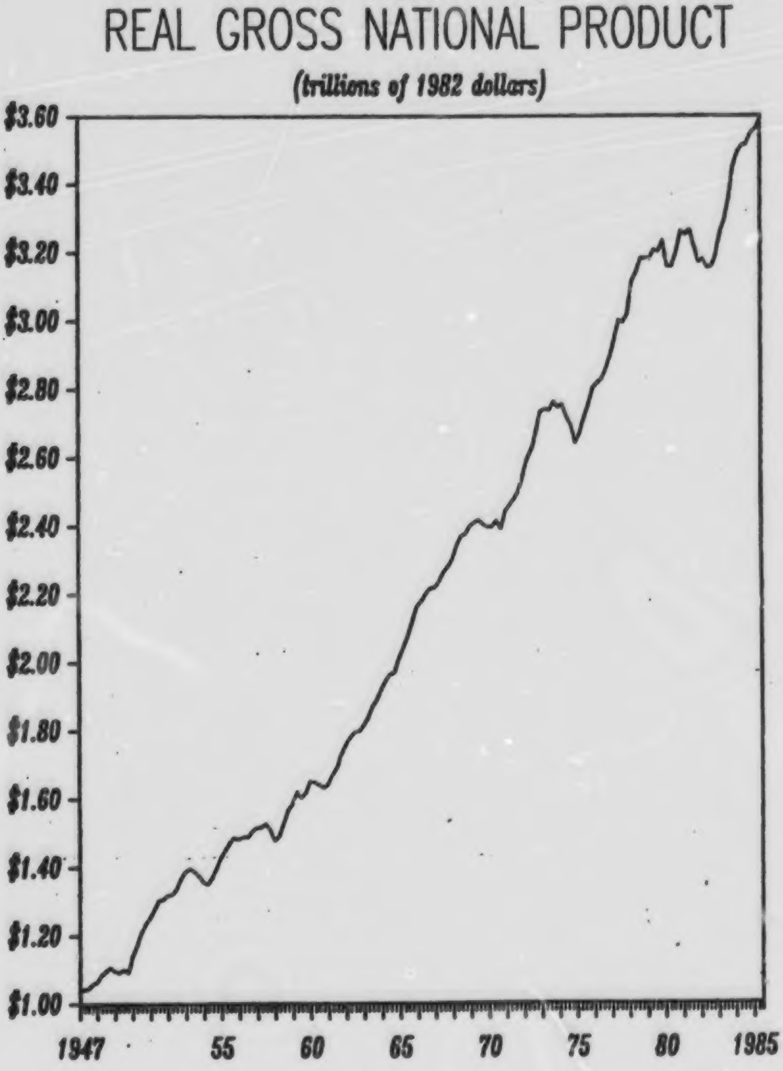

REAL GNP GROWTH
(average yearly rate)
5%
4%
3%
2%
1%
0%
47-50
51-55
56-60
61-65
66-70
71-75
76-80
81-85

Figure 2



REAL GROSS NATIONAL PRODUCT

(trillions of 1982 dollars)

Not only has growth been disappointing in comparison with our own historic performance, we also appear to be falling further and further behind in our ability to achieve our maximum *potential* growth rate. According to calculations by Edward Dennison, actual growth was only 0.9 percent below his definition of "potential" from 1948 through 1969, but 4.2 percent less from 1970 through 1973, 6.5 percent less from 1974 through 1979, and 9.8 percent less from 1980 through 1983.

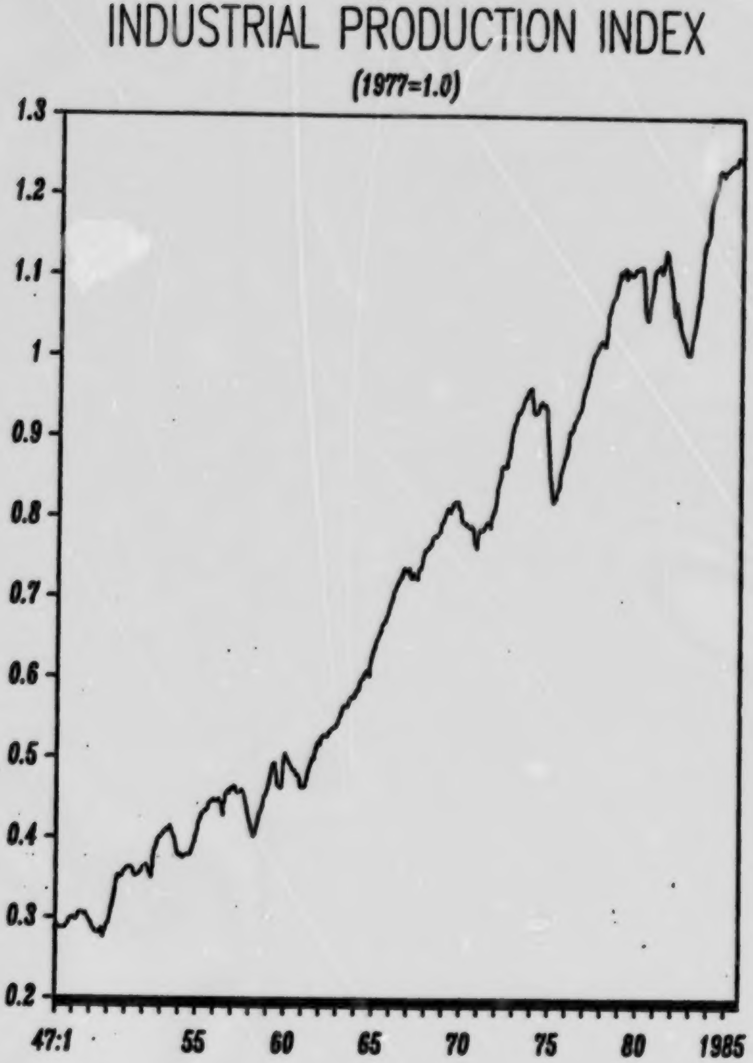
One of the major goals of the "supply-side" revolution of 1981 was to reverse this pattern of slow growth through tax reductions and a stimulation of private economic activity. If increasing the growth rate was the major objective of these proposals, evidence to date suggests that they have not done the job.

> Up to this point, it would appear that the experiment of tax reduction to promote growth had not succeeded . . .
>
> The rise of total output over the five-year period from 1980 to 1985 was not exceptionally large. In fact, it was less than in any five-year period ending before 1980; that is, in the postwar period.—HERBERT STEIN.

GROWTH: INTERNATIONAL COMPARISONS

The recent performance of the U.S. economy has been unsatisfactory, not only in comparison with its own postwar experience, but also in comparison with the economic performance of our principal trading partners. In the 1970's, annual rates of increase in real per capita income among the other developed countries exceeded U.S. rates by nearly one-fourth.

Figure 3


INDUSTRIAL PRODUCTION INDEX
(1977=1.0)
1.3
1.2
1.1
1
0.9
0.8
0.7
0.6
0.5
0.4
0.3
0.2
47:1
55
60
65
70
75
80
1985

INDUSTRIAL PRODUCTION

Industrial production has also failed to return to its historic growth trend. As the graph suggests, a major cause of the decline in both GNP growth and manufacturing production has been the recent increase in both the frequency and violence of the business cycle. There have been seven recessions since 1950, and industrial production was seriously disturbed by each one. On average, production declined 11.9 percent, as temporarily weakened markets and inventory corrections reduced the need for factory output. Perhaps more important and disturbing has been the increasing frequency of recessions. In the two decades from 1950 to 1972, the United States experienced a total of four recessions. Yet, in the past decade alone, 1973 to 1982, the American economy suffered through three recessions, each having a powerful destructive effect on industrial production.

INFLATION

The graphs demonstrate clearly that recent policies have had a significant impact on both inflation and interest rates. Inflation was the key economic problem of the 1970's, and was the source of much anguished experimentation in economic policy. Initiatives sush as the WIN campaign and the Council on Wage and Price Stability failed to tame inflation, but the recent combination of tight money and high unemployment has appeared to do the job.

Yet, the costs of this success have been high. Unemployment rose to post-Depression highs, and substantial amounts of industrial capacity continue to stand idle. Capacity utilization remains far below the level of previous recoveries, and is nearly 12 percentage points below the rate achieved during the boom times of the early 1950's and the mid-1960's. And, as Figure 5 suggests, we are still paying for lower inflation with interst rates which, corrected for inflation, stand today at very high levels. The real prime interest rate is still over 6 percent, compared with an historical average in the range of 3 percent.

With respect to economic policy, we believe Figure 7 reveals a particularly interesting story concerning the evolution of monetary policy. During the 1970's, the Federal Reserve permitted real interest rates to fall into negative ranges, a development which was highly damaging to the financial sector of the American economy. Substantial tighening of monetary policy after 1978 is apparent from the graph, and real interest rates rose in response. A substantial loosening of monetary policy after 1982 is also refleted in the charts, along with the corresponding decline in interest rates.

Figure 4

ANNUAL INFLATION RATES

(percent change in the CPI)

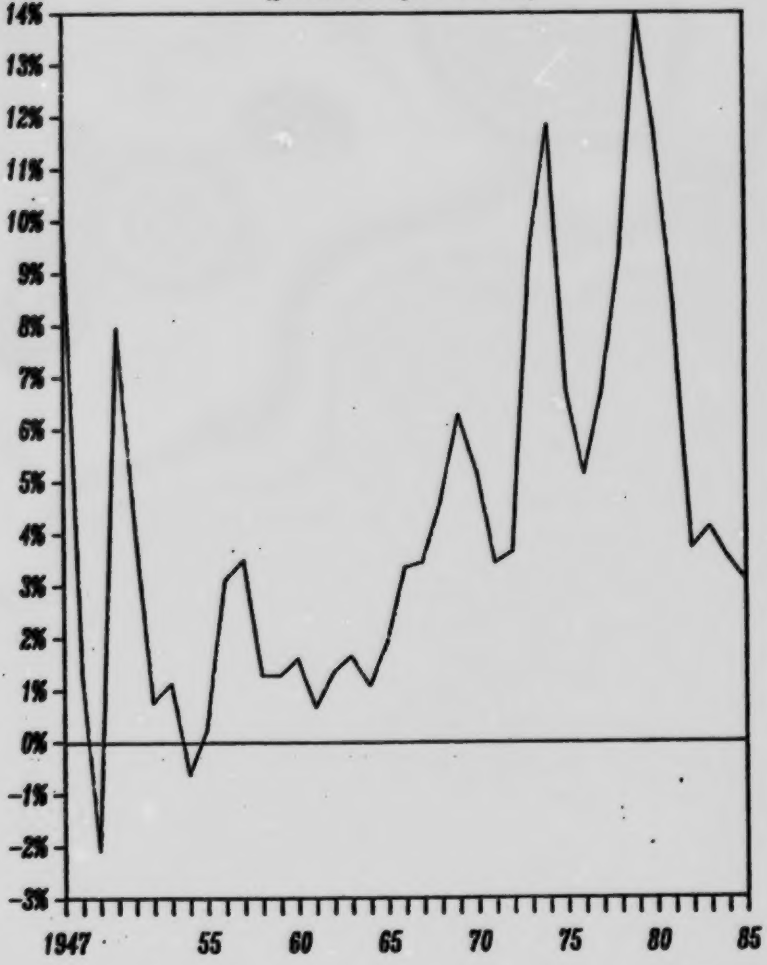


Figure 5

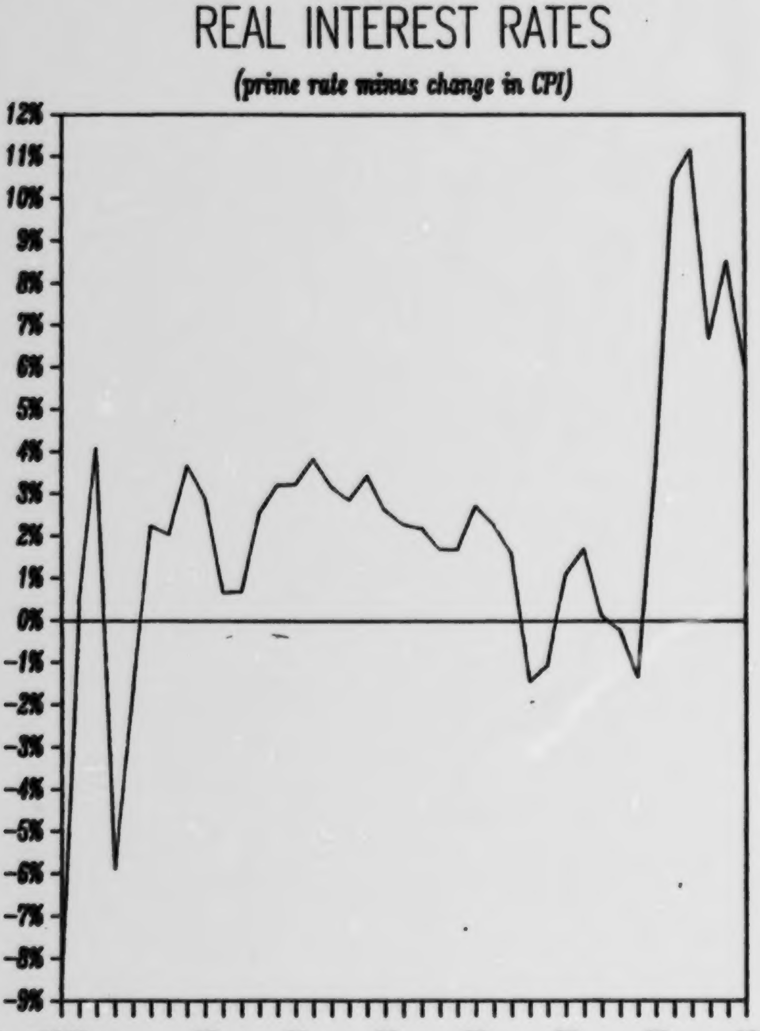

REAL INTEREST RATES
(prime rate minus change in CPI)
12%
11%
10%
9%
8%
7%
6%
5%
4%
3%
2%
1%
0%
-1%
-2%
-3%
-4%
-5%
-6%
-7%
-8%
-9%
1947
55
60
65
70
75
80
85

Figure 6

CAPACITY UTILIZATION RATE

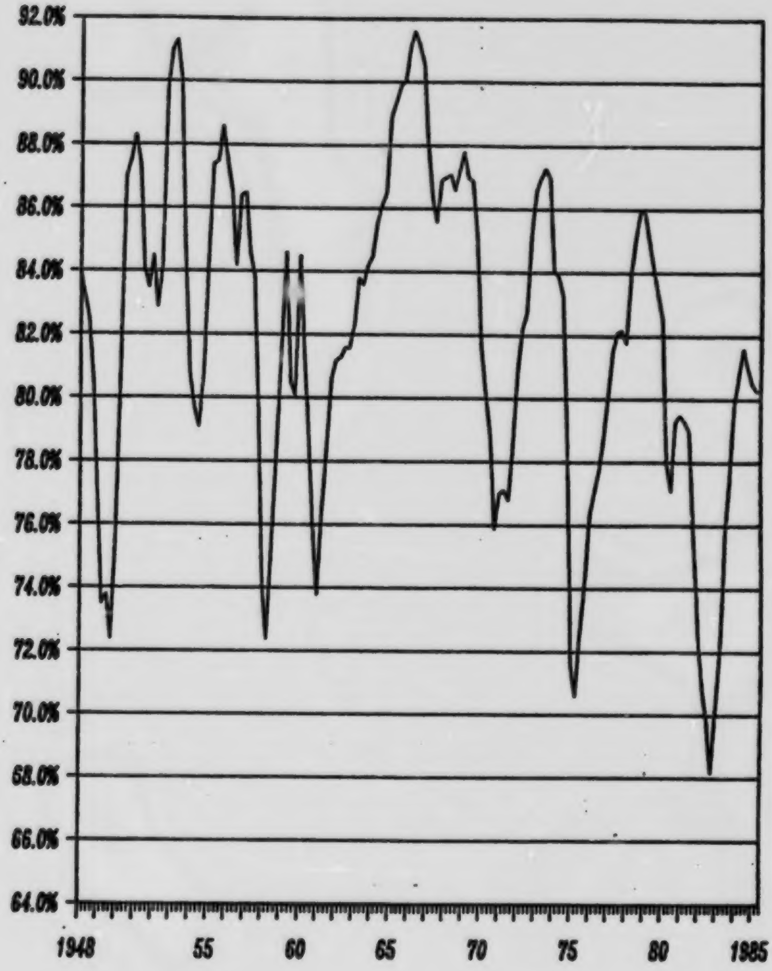
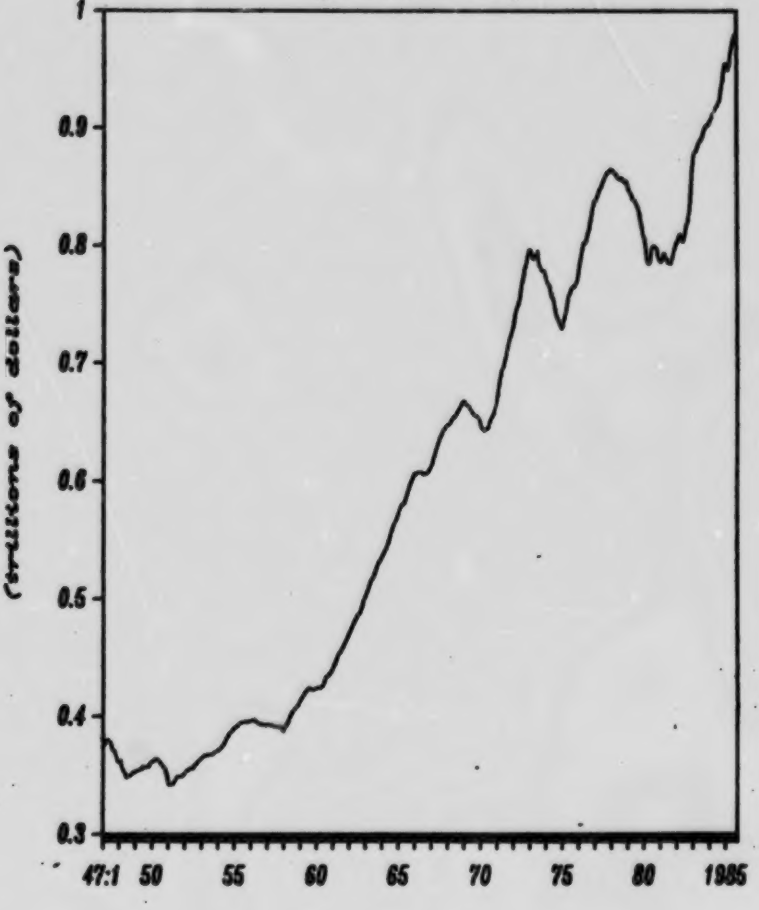


Figure 7

THE REAL MONEY SUPPLY

(M-2 in 1972 dollars)



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When this graph is set alongside the graphs on unemployment, industrial production, and real GNP growth, they conclusively demonstrate the failure of the claims of monetarists that a slow, steady growth in the money supply produces stable, noninflationary growth without recession. We believe the lessons of the recent past are simple: tight money cures inflation by creating recession.

SAVINGS AND INVESTMENT

In a broad, macroeconomic sense, it is clear that the aggregate level of investment in the U.S. economy is far below what is needed for sustained growth and international competitiveness. While problems of measurement and international comparability make precise comparisons of investment levels difficult, there is a general consensus among economists, that, over the last two decades, private business capital formation in the United States has been substantially less than the levels achieved by our major trading partners.

Recently, gross investment in the United States has risen signficantly, largely in response to the recovery of the economy from the recession of the early 1980's. But gross statistics ignore the fact that much of the new investment is in assets with a short economic life, resulting in more rapid depreciation. *Net* investment (gross investment minus depreciation) has not shown the same kind of improvement as has gross investment.

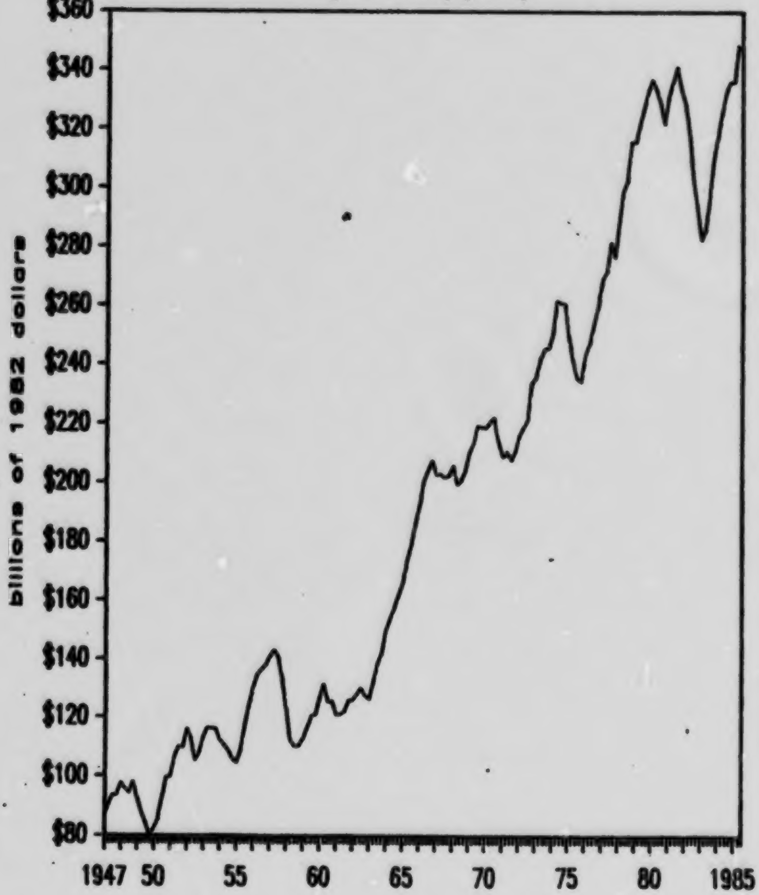
But aggregate comparisons of gross capital formation seriously distort our understanding of the investment picture in the American economy. Some of the recent apparent increase in investment comes as a result of a recomputation of existing purchases. For example, as more and more people are deciding to lease automobiles instead of buying them, the same level of car purchases is shifted from "consumption" (by households) to "investment" (by leasing companies). This shift in behavior does not add anything to *real* investment, but is responsible for some of the apparent increase shown in the national income accounts.

We believe a better picture of investment in the American economy comes from data on the investment by business in new plant and equipment as shown in Figure 8. This data series shows that investment rose strongly during 1983 and 1984, recovering the ground lost in the recession, but the rate of increase slowed markedly in the last two quarters. On the basis of this trend, we find no evidence to support the proposition that investment growth has been placed on a sustained upward course.

Figure 8

NEW BUSINESS INVESTMENT

(plant and equipment)



Part of the investment problem is due to a low rate of household savings in this country as compared with our competitors. Our personal savings rate averaged only 4.7 percent of household income in 1983, compared with 19.2 percent in Japan, 14.5 percent in France, and 11.7 percent in Germany. In addition to starting from a low base, our household savings rate has declined in recent years.

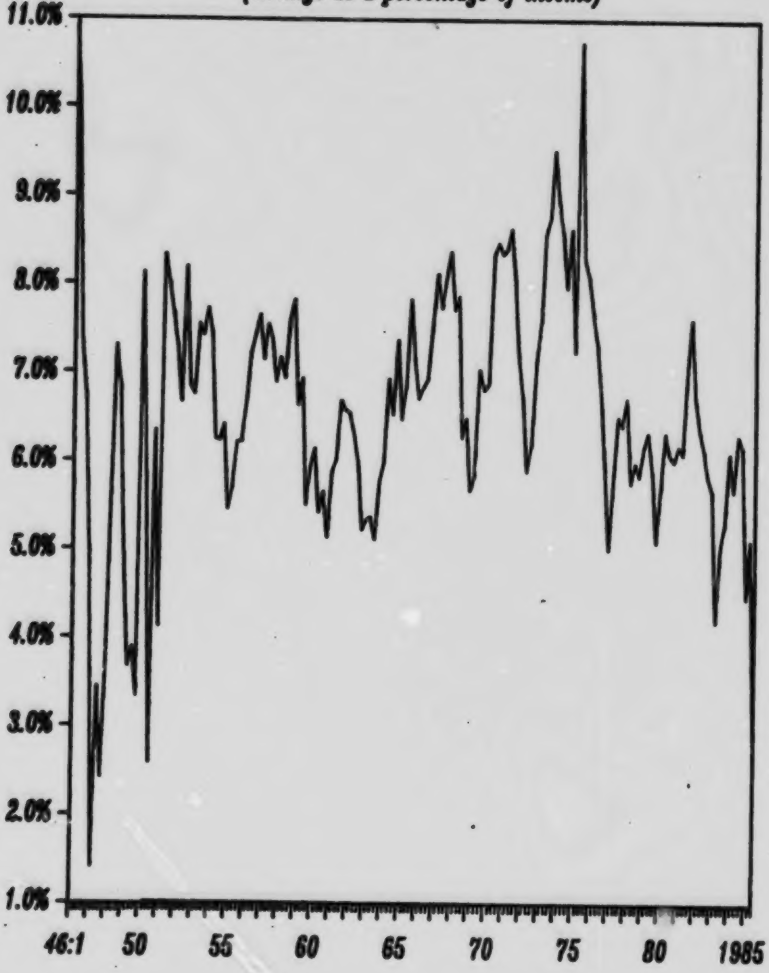
> In the last several years net national saving in the United States has been 2 to 4 percent of gross domestic product (GDP) compared to twice that in Canada, two and a half times that in Germany, and fourt imes that in Japan. While our saving rate has rebounded a little bit in 1984, it's still much lower than in the 1950 to 1980 period or that of any other advanced major economy.—Michael Boskin.

In spite of the optimistic projections of "supply-siders," the massive reductions in tax rates have not increased the overall savings rate. While the question of what actually should be counted as savings is unclear, by our standard measures, the personal savings rate has actually *fallen* during the past year. For the entire third quarter of 1985, the personal savings rate, which had been running in the 5 to 6 percent range for the past two years, dropped to 3.7 percent, which was its lowest level since 1950.

Figure 9

PERSONAL SAVINGS RATE

(savings as a percentage of income)



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This is particularly distressing in light of the emphasis which this Administration has placed on tax incentives for savings and investment. Households have apparently reacted to the tax cuts and the creation of new tax shelters such as the expanded Individual Retirement Accounts (IRA's) program by shifting around their *existing* savings so as to take advantage of the tax system, rather than undertaking any new savings in response to the changes in tax law.

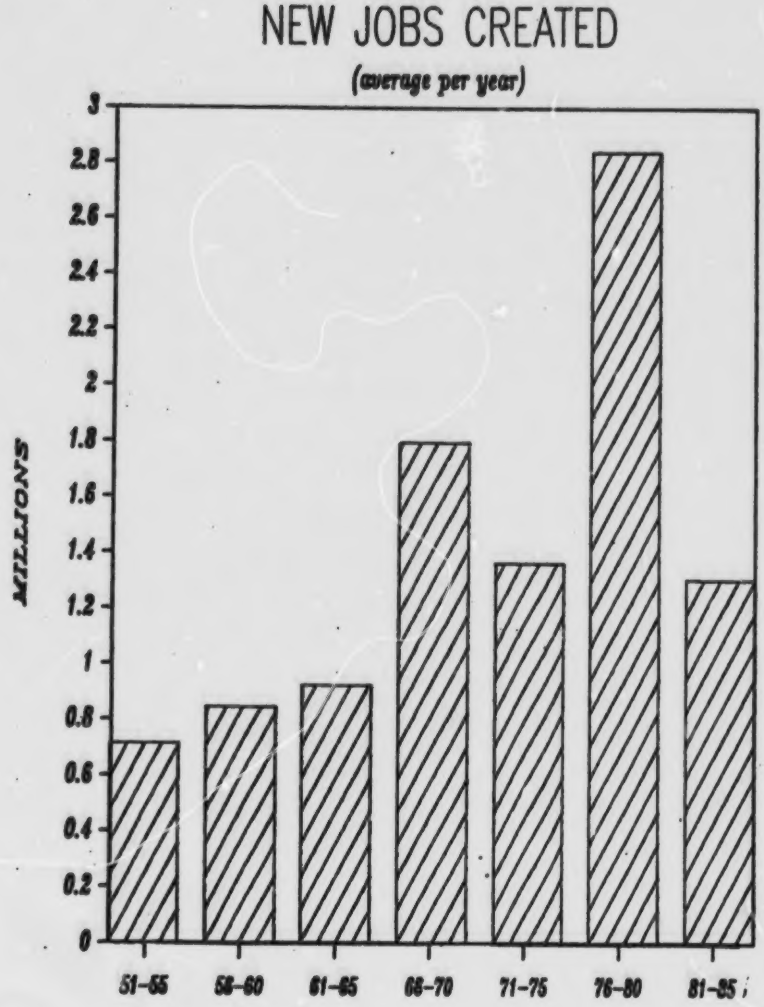
On the savings issue, we are inclined to agree with the assessments of three leading experts.

> In terms of its primary goal of stimulating private capital formation in the United States, this program has been a failure.—BARRY BOSWORTH.
>
> It also appears from my own current research that the current generations of workers and savers are saving less at the same age as their parents' generation did, which would exacerbate any problems that a fiscal deficit would cause because it would be offset against a smaller private saving pool.—MICHAEL BOSKIN.
>
> The ratio of net private savings to GNP is about the same as its average in the 1960's and 1970's. There is no evidence that the tax change designed to increase the after-tax return to savings has increased the propensity to save.—HERBERT STEIN.

One of the important, but often overlooked, reasons for our low savings rate is that slow growth has caused a stagnation in incomes of many American families. Younger families in particular have such a difficult time making ends meet in today's economy that their savings rate has dropped precipitously. From 1973 to 1981, the savings rate of younger families dropped by 75 percent. In the period from 1979 to 1983, the number of young families with no savings at all climbed by over one million.

Figure 10 establishes the important point that the American economy is a good generator of new jobs. This appears to be true regardless of the Administration in power, and the historical record suggests that we should be cautious in hailing the recent job-creating performance of the economy as anything special or unique. For example, from October 1975 to October 1980, the American economy increased the number of jobs by 12.9 million. But from October 1980 to October 1985, the economy produced only 8.62 million new jobs.

Figure 10


NEW JOBS CREATED
(average per year)
MILLIONS
3
2.8
2.6
2.4
2.2
2
1.8
1.6
1.4
1.2
1
0.8
0.6
0.4
0.2
0
51-55
56-60
61-65
66-70
71-75
76-80
81-85

The unemployment picture described in the chart is one of constantly rising "structural" unemployment—unemployment which persists over ups and downs of the business cycle and which is clearly tied to fundamental shifts in the structure of production in the economy.

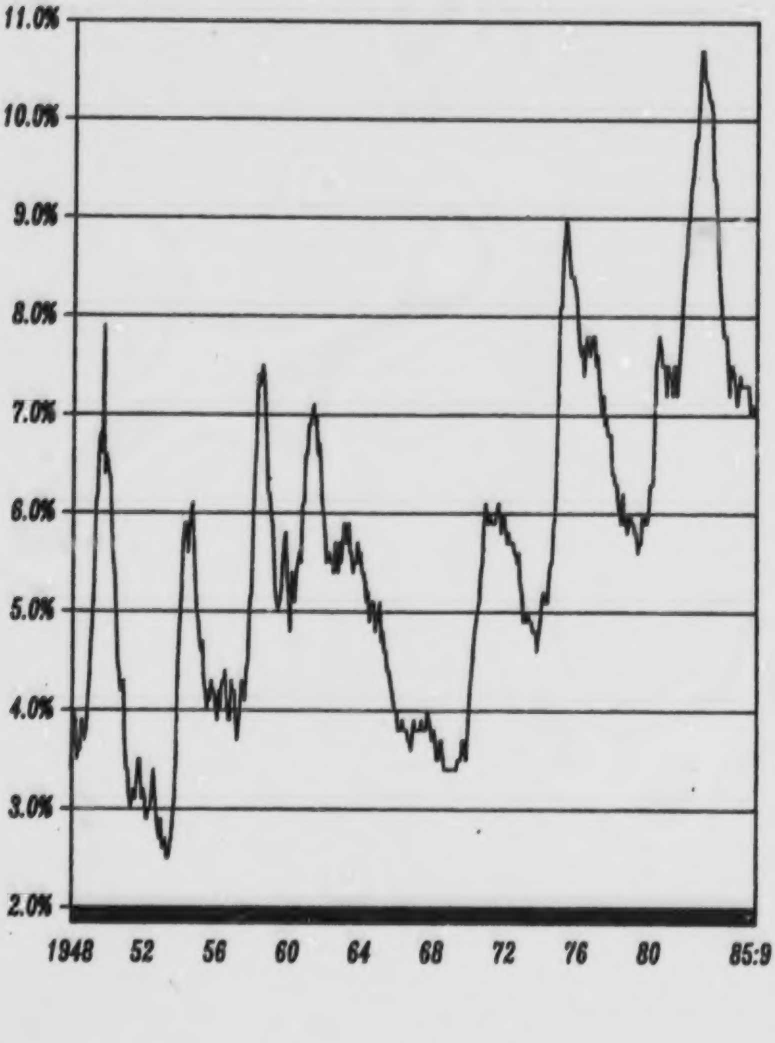
As the chart demonstrates, unemployment fluctuates with the business cycle, but underneath these cyclical variations there is a strong "structural" tend upward. During each recession, the peak level of unemployment is a little higher than the one before it, and during recovery, the trough of the unemployment curve is similarly a little higher than before.

Aggregate statistics such as these do not tell the full story on unemployment. The burden of joblessness is heavily concentrated among certain groups. Youth and, in particular, minority youth, have a particularly difficult time obtaining entry-level jobs, and consistently run unemployment rates of roughly 40 percent. The same is true for minority adults. In 1972, roughly 75 percent of adult men, both black and white were employed. By 1985, 75 percent of adult white men were employed, but the employment rate of adult black men had dropped precipitously to 64.6 percent as fewer adult black men were in the labor force at all, and those in the labor force had higher unemployment rates than white men. In recent years, the ranks of the long-term unemployed have been swelled with thousands of blue-collar production workers, both black and white, whose jobs have disappeared because of automation and foreign competition. Because heavy industry is regionally concentrated, these changes have created regional pockets of severe and persistent unemployment to add to the existing pockets defined by race.

Also not indicated by the charts is the discouraging employment experience of women workers. Between 1947 and 1980, the number of women in the labor force jumped 173 percent, and the labor force participation rate for women went from 31 percent to 51 percent. In spite of their increased participation, women did not get jobs which provided the same kinds of income as those available to men. Women who work full time earn 59 cents for every dollar earned by a man, but many women cannot find full-time work so that the average earnings for *all* women is only 39 percent of male earnings. Women make up the majority of the part-time labor force, and account for 66 percent of the country's "discouraged workers" who have given up hope of getting a job they want and need.

Figure 11

UNEMPLOYMENT RATE



PRODUCTIVITY

Productivity is the key measure of an economy's structural health because it combines in one statistic data on the performance of management, labor, capital, and technology. Failure of any of these elements to perform adequately will quickly be reflected in disappointing productivity statistics, and disappointing is exactly what our productivity performance has been over the past decade.

Labor productivity is turning out to be a major disappointment of the recovery. Depite widespread expectations of a productivity revival, it continues to lag behind its performance in earlier postwar expansions. Indeed, nonfarm activity plummeted at a 3.1 percent rate in the fourth quarter of 1985 and fell 0.2 percent for 1985 as a whole. Productivity growth is so low that this year's Economic Report of the President mentions it clearly as a major problem, while last year's Economic Report suggested that the economy had resumed the upward march in productivity.

Furthermore, a lackluster track record of nonfarm productivity from 1973 to 1984, which originally showed an average annual increase of 1 percent, has now been revised down significantly to just 0.7 percent. And recent productivity gains, which presumably reflected the beneficial impact of supply-side incentives, suffered some of the biggest statistical blows. For example, nonfarm productivity growth for 1984, when the economy exploded at a 6.6 percent rate, was sliced from a healthy 2.7 percent to an anemic 1.6 percent.

In international comparisons, our productivity growth record is even more disappointing. For the two decades after World War II (1945-1965), our annual productivity gains averaged 3.3 percent, easily outstripping inflation and allowing for increases in real wages. Since then, however, U.S. productivity growth declined dramatically to an average 2.4 percent between 1965-1973, to 1.8 percent between 1973-1978, less than a 1 percent annual growth rate over the past five years. At the same time, our major industrial competitors have had far higher growth rates in productivity over the past two decades, particularly the Japanese and the West Germans.

On the productivity question, we are inclined toward the view which Herbert Stein gave to our recent 40th Anniversary Symposium:

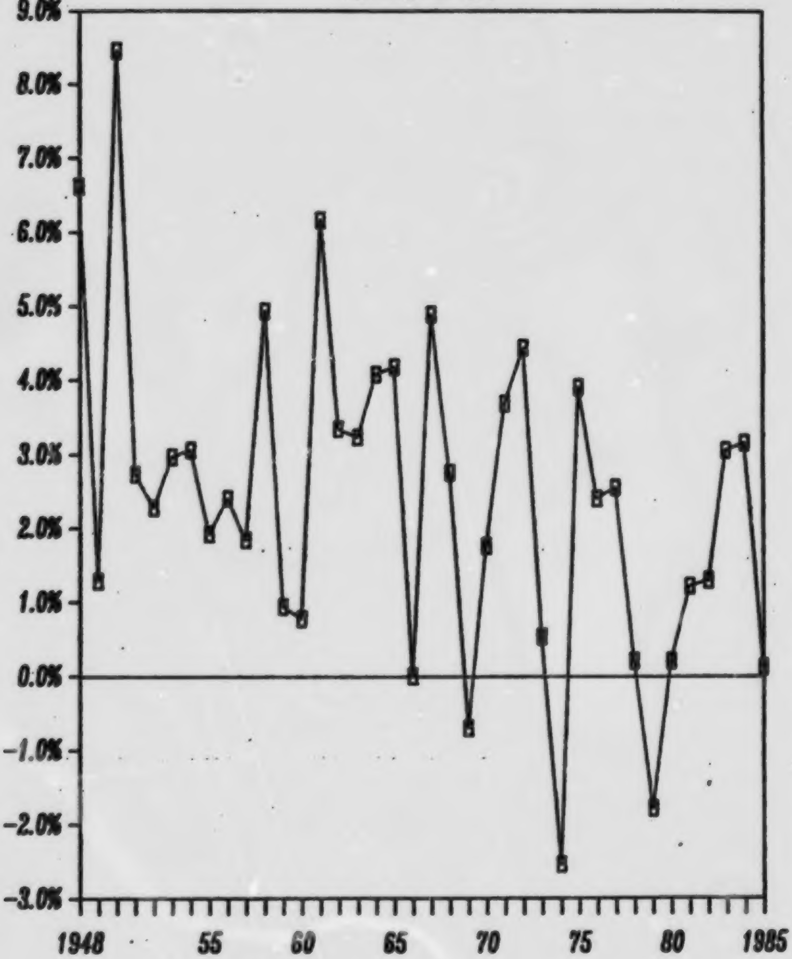
> Disentangling the trend of productivity growth from its cyclical behavior is difficult but the best estimate is that the trend of productivity growth has not increased.—HERBERT STEIN.

This apparent pervasive decline in productivity growth has important implications for many members of the work force, since without productivity growth they will be condemned to a stationary income level. Moreover, it will inevitably force our society to forgo improvements in the quality of life through a better physical environment and improvements in the education and the health of the population.

Figure 12

PRODUCTIVITY (OUTPUT PER HOUR)

(yearly change)



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TRADE

In recent years, our historic trade surplus has become a massive and mounting trade deficit, as imports increase at staggering rates while export growth is anemic. Our once-isolated economy is now intimately connected with the international trading system. In 1960, 10 percent of the U.S. GNP consisted of exports and imports; now that figure is over 25 percent, and it may well reach 35 percent by the end of the decade. Fully 75 percent of all goods produced in this country are now subject to international competition, up from 25 percent two decades ago.

And from the charts, it is clear that we are not faring at all well in this new competition. For a number of years, we have run a deficit in merchandise trade but managed to post a small surplus in the broader trade measure known as the "current account." The difference was made up by "capital income"—largely the returns to U.S. firms and investors on investments overseas.

But in recent years, the merchandise trade deficit has deteriorated dramatically. This, in turn, has led to a shift in our asset position, so that now we are a net debtor nation rather than a net creditor. We now *owe* more in payments on foreign investment in this country than we *earn* from our own investments abroad. Instead of having capital income to balance our merchandise trade deficit, capital payments add to our overall trade deficit. The result is a dramatic decline in the overall current account position of the United States. The current account deficit for 1985 of about $125 billion is nearly twice as much a percentage of U.S. GNP as it had been in the country's entire 210-year history.

As Figure 14 demonstrates, the rapid slide in our position in merchandise trade is the product of two interrelated forces: poor export performance in foreign markets and rapid penetration of American markets by foreign imports. And of the two factors, the most important is sluggish export growth. Between 1975 and 1980, both imports and exports grew by over 40 percent and the trade account remained in rough balance. But since 1980, imports have continued their rise, growing by 35 percent, while exports have actually *declined* by nearly 3 percent. The key difference between the periods is thus the dramatic change in exports.

Figure 13

TRADE BALANCE

(on current account basis)

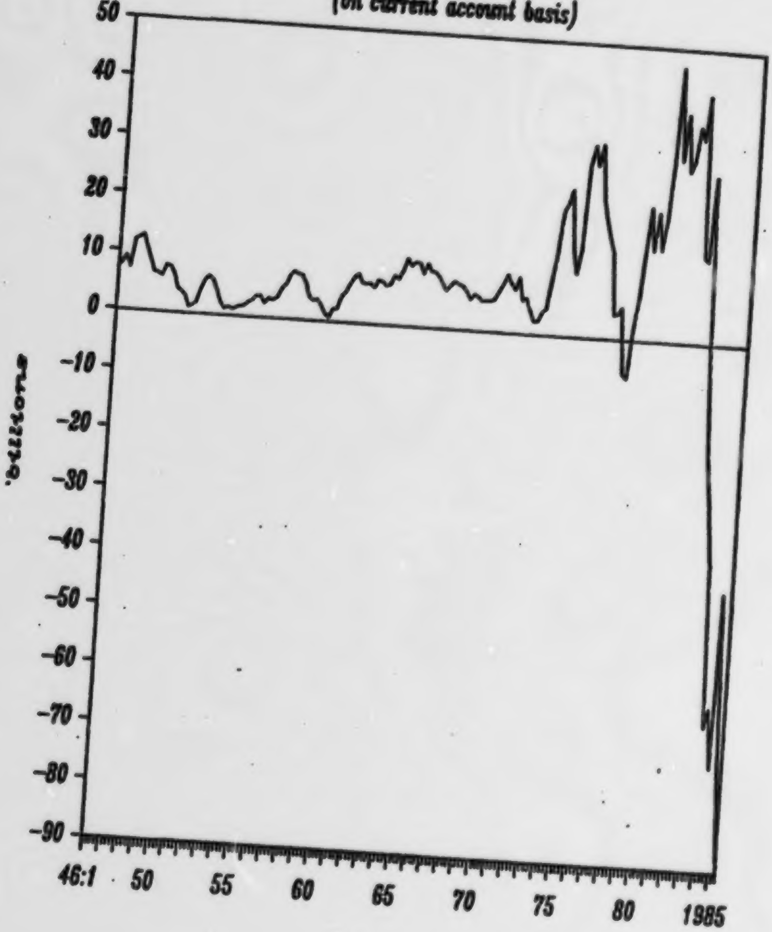
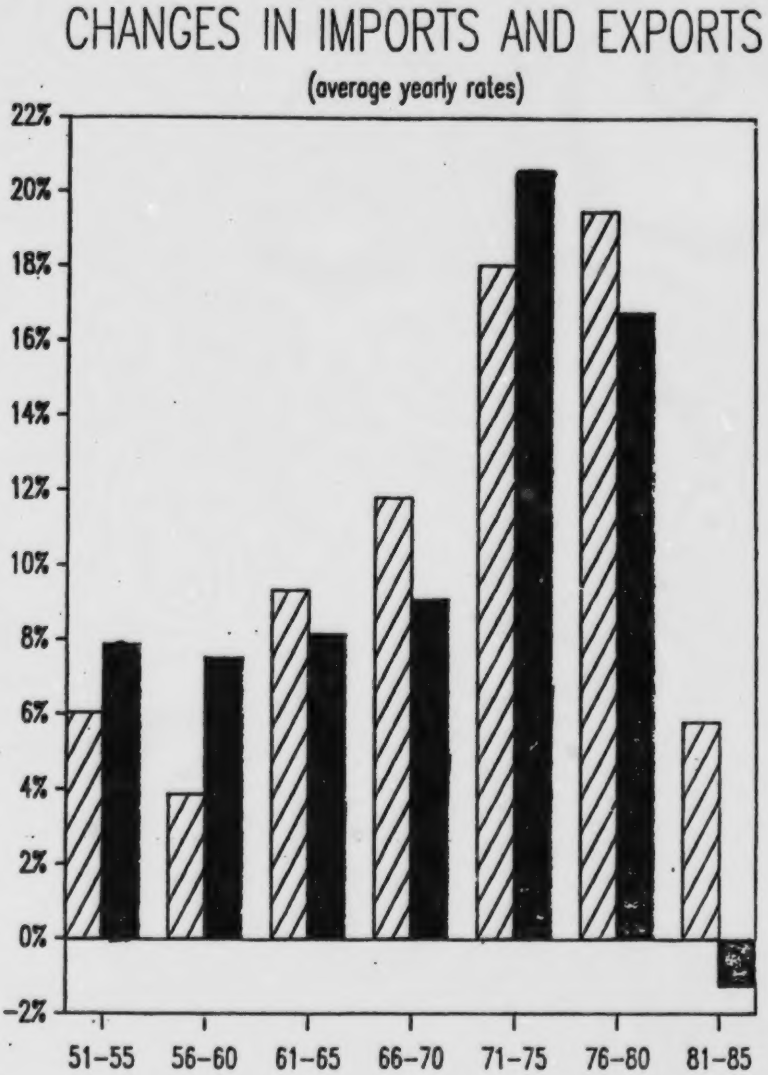


Figure 14


CHANGES IN IMPORTS AND EXPORTS
(average yearly rates)
22%
20%
18%
16%
14%
12%
10%
8%
6%
4%
2%
0%
-2%
51-55
56-60
61-65
66-70
71-75
76-80
81-85

America's trade problem is qualitative as well as quantitative. American industry is losing world market share not only in basic industry but also in many of the product areas where future growth is anticipated to be rapid.

This trend has been acknowledged even by the current Administration. The 1984 Economic Report of the President noted that:

> Between 1962 and 1980 the U.S. share of industrial countries' high technology exports fell from 30.3 percent to 23.9 percent. During the same period, the Japanese share rose from 4.1 percent to 12.3 percent and the German share stayed constant at about 18 percent.

We used to have an extremely large trade surplus in the export of capital equipment from the United States. We are now, to the tune of about $30 billion a year, a net importer of capital equipment. One of the most dramatic measures of this is that the United States prides itself on how advanced it is in the area of computers. We are now a net importer of computer equipment in the United States.

On this aspect of the trade question, we are in agreement with Barry Bosworth of the Brookings Institution, when he notes:

> The failure to maintain economic viability in American capital goods industries will be far more debilitating than the loss of competitiveness in consumer goods. Capital goods market embody technological innovations, are worldwide in scope, and rely less on price competition alone.—BARRY BOSWORTH.

In a competitive world economy, the price of uncompetitive industry is high unemployment and slow growth. In our view, the trade deficit costs the American economy dearly in terms of lost jobs and lost output. We disagree strongly with the thrust of this year's Economic Report and the testimony of Chairman Sprinkel to the effect that the trade deficit does not cost America any jobs.

On the employment consequences of the trade deficit, we are much more sympathetic to the discussion in the 1984 Economic Report of the President, which stated:

> The 1983 deficit in merchandise trade was about $65 billion, approaching twice the previous record, which was set in 1982. A deficit in the neighborhood of $110 billion is forecast for 1984, three times the 1982 level. The deficits signify loss of income and employment in those U.S. industries that depend on exports or compete with imports (p. 43).

II. THE UNCERTAIN FUTURE

From the preceding historical review, we find no evidence to support theories that the American economy has entered some sort of "new era." We do believe that economic growth for 1986 could well exceed last year's disappointing 2.3 percent, but only because of some extraordinary good luck in the form of falling oil prices. We see no evidence, however, that such an increase in the growth rate is sustainable over the long term.

And while the overall economy may turn in a decent performance in 1986, there remain severe problems with the distribution of prosperity which may ultimately put a halt to growth. We are now in the fifth year of what can only be called a full-scale depression in the agricultural sector, and we see no evidence that the current direction of the economy is likely to improve conditions in the heartland in the near future. At the same time, basic manufacturing indsutry continues to be battered by the overpriced dollar and the huge trade deficit. These problems persist despite a dramatic decline in the value of the dollar in recent months, raising the prospect that years of huge trade deficits have done permanent damage to our traded-goods sector. Finally, there is a growing body of evidence that the benefits of prosperity in the American economy are being distributed far more unequally than has been the case in the past. Our historic success in basing national prosperity on a growing middle class is being challenged by Census data which show an unmistakable movement toward increased inequality in income.

All of these concerns raise serious questions about the future of the American economy. This uncertainty is reflected in the views of economic forecasters, and in the attitudes of average citizens. We think this uncertainty is appropriate, more appropriate than either the heady optimism of the Administration or the gloomy pessimism of those forecasting a great depression just around the corner.

We believe the American and world economies are in a time of transition from old rules and practices to new ones. In a real sense, today's transition is as serious and fundamental as the transition which occurred at the end of World War II. Then, the uncertainty was created by the devastation of Europe, the prospect of demobilization in America, and anxieties about sliding back into the depression which the war had ended. Today, the uncertainty is created by technological change, international competition, the implications of debt accumulation, and the problems of excess capacity in the American and world economies.

But we believe times of transition are also times of opportunity. At the end of World War II, the creative pragmatism of world leaders built a world economic system which produced the greatest era of stable economic growth the world has known. We could do the same again today.

But times of transition involve an active engagement with the problems which create uncertainty not a flight to the spurious security of reliance on "market forces" or other forms of magic to deal with economic problems. For this reason, we intend to devote a significant section of this Report to analyzing three key problems in the economy which are responsible for much of today's uncertainty: the problems of debt accumulation, excess capacity, and increasing inequalities in the distribution of both income and economic opportunity.

We focus on these problems not because we believe they will inevitably darken our economic future, but because we must come to grips with them if we are to secure a brighter future for ourselves and our children.

THE ECONOMY IN 1986

> A deep and disconcerting dissonance among the forecasters.—BUSINESS WEEK.
>
> I think there's a much wider uncertainty out there than anybody is discussing.—ALAN GREENSPAN.
>
> The year-end crop of economic forecasts is a marvel of diversity, with predictions ranging from euphoric to glum. Small wonder. A few lucky breaks could well give the languorous recovery a second wind; bad luck could knock it to the ground.—FORTUNE MAGAZINE.

Economic forecasting has never been and will never be an exact science, but the economy is faced with an unusual degree of uncertainty about the future at this time. One recent survey found a record spread between the projections made by 50 economic forecasters. The 10 most optimistic expect growth of 4.3 percent this year, while the 10 most pessimistic foresee an advance of only 1.7 percent. The "consensus" was for growth of 3.1 percent this year, but *Fortune* magazine, which predicted last year's growth more accurately than the consensus, calls for only 1.8 percent real growth in the coming year. And *Business Week's* forecasts for industries that contribute about 75 percent of the economy's output suggest that, in general, few managers think this year will be anything but marginally better than 1985.

Projections of the average civilian unemployment rate, which was 7.2 percent in 1985, range from 8.0 pecent to 6.4 percent. Estimates of housing starts in 1986 range from 2.1 million to 1.5 million units, and domestic auto sales from 9.8 million to 6.7 million. In his latest analysis, one of the leading forecasters indicated his own uncertainty about the outlook, stating "the performance of the economy may be dismal or delightful."

There are three major reasons for this uncertainty. First, the economy is in many respects in "uncharted waters." Many key economic variables have never before been at their current levels: the trade deficit has never been so high, the savings rate has rarely been so low, the level of domestic debt outstanding is at record levels, as is the world's level of "sovereign debt." With so many indicators in unprecedented ranges, it is no wonder that uncertainty abounds.

A second reason for the vast uncertainty is psychological: over the past few years, we have rapidly developed our data-gathering abilities with the aid of newer high-speed computers. In many respects, we now know more than we did a few years ago about the state of the economy. In an earlier age, we used to feel more confident about our projections precisely because we knew so little.

But a third reason for uncertainty is that our new analytical techniques have allowed us to manipulate data and indicators far more deftly than in the past. And under such manipulation, it is fast becoming apparent that our basic data are not up to the demands of our more sophisticated analytical techniques.

Joseph W. Duncan, formerly Chief Statistician for the Office of Management and Budget (OMB) and now with Dun & Bradstreet, points out that the quality of Federal economic statistics has been slipping dramatically in recent years. Federal agencies are not collecting as much data as they have in the past and economists fear that a shortage of reliable, consistent data may result.

For example, the Standard Industrial Classification, which is the basic source of information on the structure of the economy and its performance in international trade, has not been updated since 1972, and remains heavily weighted toward older industries. The data on orders for capital goods—closely watched as an indicator of business spending plans—are based on orders *received,* not on orders *placed*. Capital goods orders placed with foreign firms, therefore, are not counted in developing our picture of business spending plans. Finally, while the Internal Revenue Service (IRS) and the Census Bureau maintain statistics on income distribution, we have virtually no reliable source of data on the distribution of wealth.

Unfortunatley, the Reagan Administration, in its determination to slash domestic spending, has cut back sharply on the government's statistics-gathering functions. The most immediate impact of the budget cuts is on the reliability of the data that the Commerce Department uses to report the GNP, personal consumption expenditures, and private domestic investment. And the IRS has reduced the statistical sample of income tax data that policymakers use in assessing the economic well-being of the population and evaluating tax reforms.

The Commissioner of the Bureau of Labor Statistics (BLS) put the problem succinctly:

> No nation has a better statistical system than the United States. Yet our data base needs to be improved, because, in a dynamic and increasingly complex economy like ours, a statistical system that stands still falls behind.
>
> As with many other activities in the Federal Government, statistics have had steep budget cuts in recent years. As both a producer and a consumer of Federal statistics, I have found some of these extremely painful.—JANET NORWOOD.

For whatever reason, today's substantial uncertainty causes the forecasters to see a year of moderate, relatively steady growth; no boom, no bust, no meaningful acceleration, not even the mildest of recessions.

OPTIMISM IN THE FACE OF UNCERTAINTY: THE ADMINISTRATION'S BUDGET

Yet, in spite of this consensus, the Administration's budget for Fiscal year 1987 is based on projections of 4.0 percent growth in 1986 and 1987, but their forecasting record does not encourage confidence in this estimate. In February 1981, the Administration predicted that output would increase by 1.4 percent in 1981 and 5.2 percent in 1982. In fact, after a rise in the first quarter of 1981, real GNP declined at an average rate of 1.8 percent for the remainder of the period, and unemployment rose to the highest level since the Depression. In 1983, the Administration predicted the weakest recovery in the postwar period, but the economy grew more than twice as rapidly as foreseen. And last year output increased by 2.3 percent, well below OMB's forecast of 4.0 percent.

By mid-1987, the recovery will be 55 months old. As it passes from middle to old age, the risks of recession outweigh those of a fresh overheated sprint, and while we see some positive signs that economic growth could be robust during much of 1986, we believe it would be more prudent to set a lower growth expectation for 1987 and beyond than the Administration projects.

Several factors suggest that growth in 1986 may exceed the 2.3 percent rate of last year:

(1) Inflation shows no signs of acceleration to date. The Consumer Price Index (CPI) rose 3.8 percent in 1985, and the Producer Price Index (PPI) for finished goods increased by only 1.8 percent. Producer prices for intermediate and crude materials both declined, by 0.3 percent and 5.5 percent respectively. The recent drop in world oil prices will lead to continued moderation in inflation as it shows up at the retail level in the early part of this year. Wages are not putting upward pressure on prices—hourly earnings rose by 3.0 percent last year, less than the increase in the cost of living. Labor costs will continue to rise at a moderate rate this year in light of an unemployment rate which is still high by historical standards and continuing pressures to hold down costs in import-competing industries. Last year, the employment cost index in the unionized sector rose by only 2.6 percent, well below the 4.6 percent in the nonunionized sector. Collective bargaining in 1986 should continue to lead to moderate settlements. The capacity utilization rate in industry was 80.5 percent in December, below the level at which prices have accelerated in the past.

(2) Financial markets showed a strong performance in 1985. The Dow Jones industrial average rose by 28 percent, and the broader indexes increased at comparable rates, with further gains since then. Interest rates declined, resulting in higher bond values. These improvements in the asset position of American households could encourage consumer demand in the early part of 1986, although the concentration of stock ownership in a very small part of the population would suggest that this effect may be small.

(3) The index of 12 leading economic indicators, published by the Commerce Department, rose in 11 of the 12 months of 1985; it has increased at an annual rate of 7.4 percent since June. The index is not an infallible guide to the future, but it is a useful measure when taken in conjunction with other factors. Among the main contributors to the rise in the index has been the jump in stock prices, the lengthening of the average work week for production workers in manufacturing, and the increase in building permits for new private housing units.

(4) The dollar is declining against major foreign currencies, and if this decline continues it could give some relief to the American traded-goods sector. The Organization for Economic Cooperation and Development (OECD) estimates that the value of U.S. export income this year should increase by nearly 9 percent, to $239 billion, and by another 8 percent in the first half of 1987.

While these four factors suggest strength in the economy in the first half of 1986, other developments raise serious questions about whether growth will continue at a 4 percent rate:

(1) Despite the stock market increase, the outlook for consumer spending is not highly favorable. The growth in household income

has slowed dramatically, primarily because of a sharp deceleration in the growth of average wages. This, in turn, is due to both wage cutbacks and a shift in the employee mix away from high wage earners toward lower wage occupations and industries.

At the same time, households have been taking on record amounts of debt, with consumer debt now at a record 18.9 percent of disposable income. With this higher debt load and the very slow growth in income, any sharp decline in consumer confidence could very well cause a major retrenchment in household spending. This would, of course, dramatically weaken the economy should it occur.

The personal saving rate was 4.6 percent of disposable income last year, the lowest since 1949. This compares with 7.5 percent in 1981. It is unclear whether the personal saving rate will remain so low, or whether it will return to a more normal level. Last year, personal outlays were two-thirds of GNP; every change of one percentage point in the saving rate has a direct impact on GNP of about $30 billion. Thus consumer demand growth could fall sharply if more traditional savings habits were to emerge this year.

(2) Business investment has slowed from 1984's rapid pace. Many companies have completed their modernization plans, and most firms have reacted to the new economics of low inflation by trimming inventories to the bone. The McGraw-Hill investment survey is predicitng a *decline* in business investment in the coming year, and present business practices suggest that a move toward rapid inventory rebuilding is unlikely.

There exists substantial excess capacity in virtually all sectors of both the domestic and international economies (see section on Demand in this Report). Surplus capacity should keep prices down, but should also make it difficult for firms to expand output or profits at a very rapid rate.

(3) The declining dollar may not be sufficient to reduce the trade deficit to a manageable level. The dollar has already fallen 20 percent in the last few months, but the trade deficit has increased. While some of this is simply a normal delay in the process of adjustment to new currency relationships, other information points to the continued existance of a trade and competitiveness problem even if the dollar declines (see the Competitiveness section of this Report). In testimony before the Joint Economic Committee, the Chairman of the President's Council of Economic Advisers stated that the trade deficit will be greater this year than it was in 1985.

(4) The Administration forecast is based on the assumption of growth in nonfarm productivity of 1.8 percent in 1986 and 2.0 percent in 1987, rising to 2.3 percent by 1991. This is highly optimistic in light of the disappointing record of the last two years. For 1984, nonfarm output rose by a strong 8.0 percent, while productivity increased by only 1.6 percent. Last year, total output per hour declined, despite a 2.8 percent rise in nonfarm production and a gain of 2.7 percent in manufacturing productivity. This was particularly disturbing—in the past, decreases in productivity have occurred only in recession or in years of very weak growth. There is no evidence to support the assumption that productivity will grow at an average rate of 2.1 percent over the next six years.

THE DECLINING PRICE OF OIL

A major but still uncertain factor affecting projections for the coming year is the recent decline in the world oil prices. This decline in the price of crude oil will have profound consequences for both the United States and the world economies. A decline in the cost of imported oil is likely to result in lower inflation, lower interest rates, and higher levels of growth in the United States and abroad. Energy-sensitive industries, such as utilities, airlines, trucking, and farming, should benefit enormously from the drop. The oil-importing developing countries will be particularly benefitied, and they may be able to divert funds formerly used for importing oil to importing more manufactured goods from the United States.

Declining oil prices could also help with our budget deficit. With energy costs a significant component of the CPI, falling oil prices could drop the inflation rate below the 3 percent level which triggers many cost-of-living adjustments (COLA's). COLA savings could be a significant portion of this year's needed deficit reduction efforts.

But there are also some major perils in the rapid oil price decline. First, the stimulative effect of lower oil prices applies largely to price reductions in the cost of *imported* oil. Lower prices for domestic producers will have a retarding effect on that sector of the American economy. This is a particular problem for the oil-producing regions of Texas, Oklahoma, and the Southwest. A major portion of our recent economic growth is concentrated in those regions and, if the declining oil price puts a damper on growth in this region, it could create significant problems for the entire economy.

Declining oil prices could also bring even more pressure on the troubled farm economy. In oil-producing regions, mineral rights have held up the value of farmland when farm prices were declining across the country. If oil prices continue to decline, those farmers won't have that prop anymore.

The financial reprecussions of the oil-price decline could also be quite severe. Domestic financial institutions are holding large portfolios of loans to domestic energy producers and to foreign governments which depend heavily on energy for their income. Falling energy prices could touch off a serious liquidity crisis in the financial sector.

Lending for oil and gas development in Oklahoma was at the root of banking's most spectacular crisis for recent times: the collapse of Continental Illinois National Band & Trust Company in 1984. Continental Illinois had invested sums worth half its capital in energy loans made by the Penn Square Bank of Oklahoma City. After Penn Square failed, Continental had to write off more than $250 million in bad loans; this and other losses precipitated the modern equivalent of a run on the bank.

Energy loans are responsible, along with agricultural loans, for the failures of banks in Oklahoma and Western Kansas this year, according to the Federal Deposit Insurance Corporation (FDIC). Texas banks, once among the most porfitable in the country, are now suffering because of deterioration in their energy protfolios.

Recent changes in the domestic oil industry could also turn out to be major sources of trouble if the oil-price decline persists. The mergers of Chevron-Gulf, Occidental-Cities Service, and Mobil-Superior all occurred as a result of raids or the threat of raids. These companies took on high levels of debt, and could be in serious difficulty in the near term if the price of oil continues to decline.

One exploration company, Global Marine, had been struggling with its $1.1 billion in debt for years. The dip in oil prices convinced Global Marine, the biggest publicly owned company of its kind, to file for Chapter 11 reorganization and renegotiate its debts with the protection of the Federal bankruptcy courts. There are fears in the financial community that there could well be other Global Marines in the near future.

The situation of debt-burdened, oil-producing countries such as Mexico and Venezuela will also be made more difficult. The dramatic slide in oil prices will result in a $4 billion drop in Mexican oil export earnings to $8.5 billion. A beneficial feedback from a one-half-point gain in economic growth rates among industrial nations and a one-point drop in interest rates—expected by many economists from lower oil prices—would cut the new money requirement by only $1 billion in 1987 and by $1.5 billion in 1989. Without the favorable feedback, it is estimated that Mexico's new money needs would be $4.7 billion this year, rising to $7.7 billion in 1987, $8.4 billion in 1988, $7.4 billion in 1989, and $7.9 billion in 1990.

New lending on this magnitude to the oil-exporting debtor countries could overwhelm the Treasury plan for resolving the world debt crisis.

III. THE OUTLOOK FOR THE FUTURE

Thus, on balance, we believe that oil price declines, combined with falling commodity prices, create a macreconomic environment in which reasonably strong growth is possible for 1986. We believe, therefore, that it is reasonable to expect growth to be somewhat higher than last year. Depending on the course of energy prices, it could well be possible to achieve a rate of growth in real GNP above 3 percent for the coming year.

But the very factors which make 1986 seem like a good year for growth are cause for concern about the longer term. Falling commodity prices are not good for commodity producers, and the enormous overhang of debt creates massive uncertainty in such an environment of falling prices.

Over the short run, therefore, we see a reasonably healthy American economy in 1986, but very substantial uncertainty about its long-run prospects. In this, we agree with Lawrence Chimerine:

> We have had about 18 months of extremely slow and erratic growth in the U.S., and while I wouldn't characterize the economy as being in very bad conditions, I think the health of the economy is being overstated by many people . . . and in particular there is nothing, no evidence at all to suggest that long-term growth prospects have improved in recent years as a result of some of the policy actions that have been implemented.—LAWRENCE CHIMERINE.

We hope that this combination of good prospects in the short run, combined with substantial uncertainty in the long run, will create a positive climate for resolving some of the more difficult policy issues in the national economy. We believe that 1986 should be a good year for making substantial progress on deficit reduction, and in a later section of this Report we will suggest that it should be possible to meet the deficit target of $144 billion for Fiscal Year 1987. We also believe that 1986 should continue to shift toward a growth-oriented monetary policy which is already underway at the Federal Reserve.

But we also believe that 1986 should be a year in which economic policy develops more effective responses to some of the deeper structural problems in the economy: stagnant productivity, runaway trade deficits, growing excess capacity in the world economy, increasing inequality, and a huge increase in both speculation and debt. In the hope that such problems will receive greater attention this year then they have in the past, the next section of this Report will examine in some detail the three basic problems of debt, demand, and family incomes.

THE GREAT DEBT

> We are an economy running on borrowed time, and on borrowed money.—PAUL VOLCKER.
>
> Excess debt creation has many of the characteristics of intoxication. The early stages are heady and expansionary. But the hangover is inevitable and unpleasant.—ALAN GREENSPAN.

Previoius generations have faced tough economic challenges—the Great Depression, the Great War—ours is the challenge of the Great Debt. Over the last five years, we have run up unprecedented amounts of public, international, and private debt.

Debt fundamentally represents a postponement of unpleasant confrontations with reality. The essence of a debt relationship is described in the merchants' phrase: "Buy now, pay later."

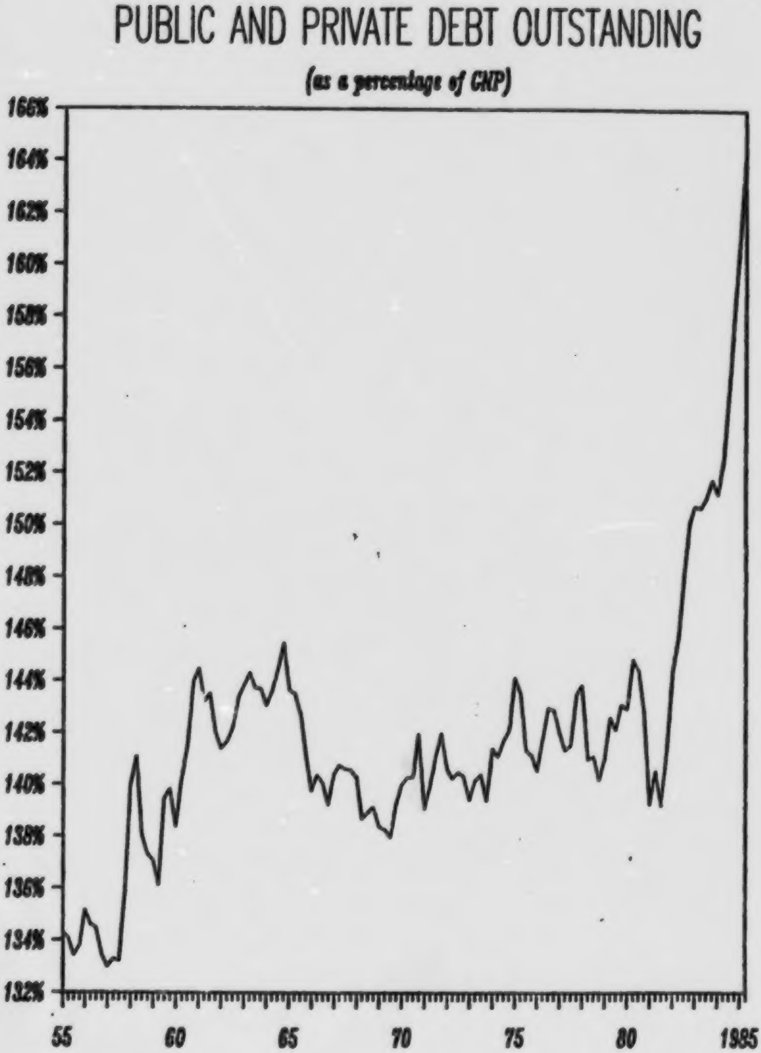
It is this "pay later" aspect of debt accumulation which is of most concern to us. We are concerned about Mr. Greenspan's "hangover," and concerned that the huge overhang of debt could jeopardize our future and possibly precipitate a crisis and a repeat of the Great Depression.

While there have clearly been significantly signs of strain in our financial institutions of late, so far, we have weathered each crisis. But the essence of debt is that it is explosive—and ability to contain one crisis does not necessarily mean an improved ability to deal with the next one.

DEBT FACTS

Credit-market debt now stands at an ominous 1.65 times GNP compared with 1.45 a decade ago. There also is a sharply expanding, hidden debt that doesn't show up in the figures. For example, the official tally doesn't consider the immense leverage inherent in financial futures and options. Buying a stock index future, for example, requires a down payment of only 6 percent. By using one security bought on margin as collateral for other purchases, leverage can be piled on leverage.

Figure 15


PUBLIC AND PRIVATE DEBT OUTSTANDING
(as a percentage of GNP)
166%
164%
162%
160%
158%
156%
154%
152%
150%
148%
146%
144%
142%
140%
138%
136%
134%
132%
55
60
65
70
75
80
1985

For many years in the postwar era, debt grew at the same rate as the economy. The ratio between total debt outstanding the GNP remained at a remarkably steady 1.4:1. But, beginning in the 1981-1982 time frame, something seems to have happened to that relationship. From 1981-1984, the ratio of debt to GNP has risen about 20 basis points (a basis point is one-hundredth of a percentage point) to 1.6:1—"a very large change in a ratio of this nature," according to Federal Reserve Bank of New York President E. Gerald Corrigan. An extrapolation of the record trend suggests that, by 1995, the United States could have $2.25 of debt for every dollar of economic output.

The huge Federal deficits of recent years have contributed importantly to the debt explosion, but borrowing has also surged in the private sector. Since 1977, the national debt has risen by over 140 percent. In the same period, the total outstanding debt of households and business firms has increased from $2.6 trillion to $5.5 trillion, or by 113 percent.

Within the private sector, consumer credit has been increasing most rapidly, at a 20.1 percent annual rate in 1984, outstripping borrowing by nonfinancial business (14.4 percent) and by people taking on home mortgages (11.8 percent). State and local governments increased their borrowing by 12.2 percent in 1984, up from 11.4 percent a year earlier and significantly lower growth rates in earlier years.

This table, based on Federal Reserve System data, shows the growth of outstanding domestic nonfinancial debt (in billions) by major categories since 1975. Data for 1985 are as of the second quarter.

TABLE 1

	U.S. Government	State and local governments	Home mortgages	Consumer credit	Nonfinancial business
1975	$446.3	$220.2	$482.9	$223.2	$843.5
1980	742.8	296.9	940.2	376.1	1,423.5
1985	1,467.9	445.5	1,378.1	638.2	2,173.3

CORPORATE DEBT

Over the last two years, there has been an unprecedented increase in the ratio of debt to equity in American business. Debt finance creates an obligation for the company which must be repaid no matter how well the company does, while equity finance creates only an obligation to share profits with stockholders. This increase of debt to equity is referred to as increasing the "leverage" on a company's books, and has been accomplished through such devices as debt-financed mergers, "leveraged buyouts" (where employees borrow huge amounts of money to buy up outstanding shares owned by outside stockholders), and debt-for-equity swaps in the marketplace.

While corporate debt has grown, corporate equity has shrunk because of companies buying back their own stock, declining by $77 billion in 1984 alone. Since 1977, equity is down by $45 billion. In terms of new capital issues, borrowing now represents 81 percent of the external sources of funds of corporations compared to 56 percent in 1975 while new stock offerings declined from 35 percent during 1975 to 14 percent currently.

By the end of 1985, American corporations will owe a total of $1.56 trillion, the highest in our history. Corporate debt exceeds total net worth by 12 percent.

With all this borrowing, the quality of corporate debt continues to slide. In third-quarter changes of ratings of corporate long-term debt, Standard & Poor's downgraded nearly four times as many securities as it upgraded, accelerating from a 3:1 ratio in the second quarter. By smaller margins, downgradings have outpaced upgradings in every quarter since the beginning of 1984.

A major factor behind both the growth in corporate debt and its deteriorating quality is the recent wave of mergers and acquisitions. Between 1978 and 1981, U.S. companies expended over $100 billion in corporate resources to acquire existing corporate assets through tender offers. In 1984 alone, firms spent $140 billion in mergers, acquisitions, and leveraged buyouts, and the pace has not slackened appreciably this year. So fierce is the merger action that, according to one Wall Street executive:

> You can almost sell anything you can call a business.—KENNETH H. MILLER, Merrill Lynch.

The current merger wave started forming in the mid-1970's, as the gap between companies' stock market value and their underlying asset value grew enormously. But in sharp contrast to the epidemic of stock-for-stock acquisitions by which the conglomerate was created in the 1960's, the economics of the latest acquisition binge hinge on the prolific use of debt.

By borrowing heavily to buy control, an acquirer can use the target company's own assets to finance the deal. Once in charge, the new owner can sell off pieces of the company and divert cash flow to pay off acquisition loans.

Increasingly, targets of unwanted buyout bids are fighting debt with debt. Unocal, for example, fought off a takeover bid by issuing $4.1 billion in new debt securities to shareholders in exchange for their shares.

The surge in debt-financed acquisitions and share repurchases is severely distorting corporate America's balance sheet. In 1984, some $78 billion in equity vanished, and companies added a staggering $169 billion in new debt. That is the widest such yearly gap ever, according to Salomon Brothers.

Many of these mergers are financed by use of "junk bonds." Once virtually excluded from the public markets, companies with credit ratings below investment grade in the last five years have issued $30 billion worth of bonds. These junk bonds typically bear interest rates from 3½ to 5 percentage points above those for blue-chip issues.

Most large mergers produced no new factories, no new technologies, no new jobs. Nor did they enhance the ability of companies to compete more effectively in world markets. Instead, they represented mere rearrangements of corporate assets. In addition to driving up interest rates, takeover battles took up the time of managers, cost money, and may have caused corporate management to shift their horizons from long-term growth to short-term defense of their jobs and their firms. In light of this evidence, we take seriously the view of management theorist Peter Drucker who writes:

> There is a great deal of discussion on whether hostile takeovers are good or bad for the shareholders. There can be absolutely no doubt, however, that they are exceedingly bad for the economy. They force management into operating short-term. More and more of our businesses, large, medium-size, and small, are not being run for business results but for protection against hostile takeover. This means that more and more of our businesses are forced to concentrate on results in the next three months.—PETER DRUCKER.

This increased "leveraging of corporate America" creates a potential time bomb in the financial structure of American industry. Firms with high debt-to-equity ratios are very vulnerable to a decline in demand for their products because they must keep up their debt service payments no matter what their earnings stream.

The experience of companies in hard-pressed industries suggest the possible consequences of these financial policies. For example, there is currently at least $70 billion of questionable loans to shipbuilders held by the money center banks, and U.S. shipowners have already defaulted on more than $374 million in guaranteed loans. The General Accounting Office (GAO) forecasts that $500 million more in ship defaults will occur before the end of 1986.

As a nation, increasing our collective debt-to-equity ratio increases the risk of substantial bankruptcies in the event of a downturn in the business cycle. Since there is no evidence that we have repealed the business cycle, there should be real cause for concern about the increasing vulnerability of our corporate sector to future fluctuations.

> American corporations are far more vulnerable coming out of the 1980–1982 recession than they were after the 1974–1975 recession. Since 1982, cost of servicing debt has been absorbing 50 percent of the entire cash flow of corporations while during the 1976–1979 recovery the cost averaged only 27 percent of cash flow. The combination of deflation, deregulation, and a strong dollar make this a very dangerous equation.—FELIX ROHATYN.

HOUSEHOLD DEBT

Since the fourth quarter of 1982, consumer spending has been a major driving force in U.S. economic growth. But much of that consumer spending has been supported by increased indebtedness rather than increased household income.

Consumer debt has tripled in the past 10 years and grew at an annual rate of 21 percent in the first half of 1985 compared to the previous trend rate of about 13 percent. During 1984–1985, bank credit card debt increased 67 percent. In 1985, the ratio of consumer debt to disposable income reached a record high of 18.9 percent. At the same time, consumer savings hovered near record lows.

Delinquencies on bank-card loans are near their all-time high, with 2.88 percent of all the payments for such loans more than 30 days late at the end of September, up sharply from the 2.1 percent delinquency rate recorded for a year earlier.

Slowdowns in wage growth have necessitated the continual expansion of consumer debt in order to maintain expected living standards, and to fuel economic growth. Because of debt loading, consumer savings rates in the United States dropped to a record low of 2.8 percent in September 1985.

This rapid accumulation of debt by households creates a double-edged problem. If households cut back on their borrowing, consumer demand in the economy could slow dramatically and bring about a downward spiral of declining incomes and declining demand. If households keep assuming new debt, they only increase their future vulnerability to an economic downturn caused by other factors.

FARM DEBT

In response to the 1970's era of rising farm prices and appreciation in farmland, American farmers took on a record $213 billion in debt. But several years of recession, a strong dollar, and sliding commodity prices are expected to cut farm income from $34.5 billion in 1984 to an estimated $22.5 billion in 1985. With falling incomes, farmers are increasingly unable to repay their loans.

While many farmers have manageable debt loads, thousands of others, including many younger farmers just starting out, are saddled with debt burdens which put them at risk of losing everything in the event income cannot keep up with debt service obligations. Local attempts to reduce the burden of debt service (for example, by reducing property-tax assessments on farmland) merely shift the burden from farmers onto nonfarmers in hard-pressed rural economies. Farmers owe $67 billion to the Farm Credit System (FCS), and the system itself is in grave financial trouble. By many estimates, at least 15 percent of the FCS loans are uncollectable, a potential loss of some $11 billion.

INTERNATIONAL DEBT

A few short years ago, a discussion of the "world debt problem" would have involved only a discussion of the debt of the developing world. No longer. During 1985, the United States became a debtor nation for the first time in 68 years. Since then, we have been going into net foreign debt faster than any country in recorded history. Last year, we imported capital at the unprecedented rate of over 3 percent of GNP per year. At present rates, many estimate that we could accumulate a net foreign debt of over a trillion dollars by the mid-1990's.

Table 2 shows the erosion of the net asset position of the United States in recent years.

TABLE 2.—*United States net asset position*

Year:	Amount (billions)
1980	+$106.1
1981	+143.1
1982	+149.5
1983	+106.0
1984 (estimate)	+2.0
1985 (estimate)	−100.0

Much of the reason for this is to be found in the huge budget deficits which were produced by the "supply-side revolution."

> In 1980, enthusiasts for tax reduction as the route to economic growth pointed to the example of Puerto Rico. Skeptics, including me, replied that there was a vast difference between a small island that could import large amounts of capital from the rest of the world and the United States that was half of the world economy. But it turned out that the United States could be much more like Puerto Rico than anyone had expected.—HERBERT STEIN.
>
> I think we now know the miracle of supply-side economics. The miracle is that the foreigners supply a large part of the goods and the foreigners supply most of the money.—FRED BERGSTEN.

Our current account deficit in 1985 was about $125 billion, much larger than the current account deficit of all the developing countries taken together in 1981, the year before their debt crisis broke out. With these huge current account deficits, we have accumulated more net foreign debt in each of the last two years than the cumulative historical total of either Brazil or Mexico, previous holders of worlds records for indebtedness.

This huge debt accumulation has had a mixed impact on the American economy. On the positive side, without capital from around the world, the U.S. recovery of the last three to four years simply could not have occurred. Capital imports last year financed more than half the increase in all gross investment in the economy through the recovery period. Without those capital inflows, U.S. interest rates, according to the estimates of Stephen Marris of the Institute for International Economics, probably would have been about five percentage points higher than they turned out to be.

At the same time, it has made us for the first time dependent on foreign capital for the successful operation of our economy, and vulnerable to changes in economic conditions that could cause foreign investment to slow sharply or to leave the United States. In addition, it has helped drain Western Europe and many developing countries of essential investment capital necessary for world economic growth.

Becoming a debtor nation is a huge reversal of roles for the world's most powerful economy.

> Suffice it to say that there is no compelling example in all of economic history of an economy which was advanced at this stage of history which managed to finance its long-term growth over decades, not quarters or a year or two as we tend to think of in Washington, by financing its invest-

> ment by importing capital. Usually the wealthy countries have been exporters of capital.—MICHAEL BOSKIN.

This huge accumulation of international debt by the United States raises two fundamental questions about our economic future:

First, "What will we have to do to pay back the debt?" Our huge international debt burden represents a claim by foreigners on future production in the United States. In order to repay these debts, we will have to run trade *surpluses* in order to balance out our capital account, and trade surpluses will be both difficult to achieve and unpleasant for many Americans.

If the lending stops at a point where the United States has accumulated sufficient debt to require interest payments of $75 billion a year, that would require us to earn a surplus of $75 billion a year to pay what is demanded by our creditors. That means selling that many goods and services to the rest of the world. But at the moment, we are running a deficit on the current account of roughly $150 billion. To switch from a deficit of $150 billion to a surplus of $75 billion would be an enormous, and unprecedented, shift in resources.

Trade surpluses of this magnitude would mean a reduction in our living standards as domestic production is used to satisfy foreign creditors rather than domestic consumers. There is a disturbing analogy between today's "austerity" which lies ahead for American consumers when our creditors do to us what we as creditors are doing to the third world.

Second, "What happens if foreigners stop lending to us?" There is widespread agreement among economists that the present situation cannot last forever.

> We know it can't continue forever, at least at current interest rates. Eventually foreigners will become more and more dubious of putting larger and larger fractions of their portfolios into dollar denominated assets and will demand higher returns to compensate them for greater risks.—MICHAEL BOSKIN.
>
> Well, I recently came to the remarkable conclusion which I commend to you and that is that if something cannot go on forever it will stop. . . . Our foreign debt cannot rise forever relative to the GNP. But, of course, if it can't, it will stop.—HERBERT STEIN.

A gradual reduction in the willingness of foreigners to lend money in American markets would drive up domestic interest rates and precipitate a major slowdown in capital investment in the American economy. But there is also the possibility of an abrupt cessation of foreign lending.

A large portion of foreign investment in the United States today is in liquid bank deposits or readily marketable securities. Of the $1 trillion total foreign investment in the United States, only $160 billion is invested in businesses, farms, real estate, and other property. Rather than a sign of the strength of our economy, this is an indication that much of this investment is potentially short term or speculative. Such short-term investments by foreigners could be withdrawn virtually overnight, creating a liquidity crisis for our financial institutions.

The recent story of Continental Illinois Bank shows the danger of this strategy. Like the country as a whole, Continental financed a large portion of its new lending by borrowing from foreign investors—selling short-term Certificates of Deposit (CD's) to investors from Amsterdam to Hong Kong. When there were rumors that the bank's loan portfolio might be in trouble, these foreign investors rushed to cash in their CD's and get their money back out of the country. It was this "run on the bank" by foreign investors which caused the failure of Continental.

Even if neither of these scenarios develop, being a debtor nation will exert a subtle set of constraints on our ability to deal with pressing domestic and international problems. This situation is described well by Kevin Phillips:

> If you're in a situation where you're having a lot of your debt financed by, say, Japan or other countries and all of a sudden you get yourself in a box where you're not free to take very substantial trade measures because, if you do, the countries with which you have a major trade deficit will refuse to turn around that deficit, take their surplus, and invest it in financing the U.S. budget deficit.—KEVIN PHILLIPS.

THE OTHER DEBTORS: THE THIRD WORLD DEBT SITUATION

The total debt of the nonoil developing countries rose from about 22 percent of their GDP in 1973 to 35 percent in 1983. In 1985, Lesser Development Country (LDC) debt was over $800 billion.

The debt situation in Latin America is on the brink of renewed crisis. Debtor countries have covered their debt servicing costs only by going further into debt and by a rapid swing from trade deficit to trade surplus. This is not a long-term solution. These countries have been increasing their debt faster than their exports or their GNP. Thus, their real debt burden is higher today than it was when the last "crisis" began in 1982.

TABLE 3.—EXTERNAL LIABILITIES OF DEVELOPING COUNTRIES, 1980–85

[In billions of U.S. Dollars]

	1980	1981	1982	1983	1984	1985
Total external debt	610	702	775	843	895	970
Annual debt growth rate		15.1	10.4	8.8	6.2	8.4

Note.—1983 figures are preliminary. 1984 and 1985 are estimated.
Source: World Bank.

FINANCIAL SYSTEM VULNERABILITY

To the trillian dollars of third world loans, we have to add the dramatically increased use of debt, both conventional debt and junk bonds, in all types of takeovers and leveraged buyouts and the risk involved if we were to enter a serious recession. One does not have to be Cassan-

> dra to be concerned about the safety of our financial institutions and to their vulnerability to sudden jolts.—FELIX ROHATYN.
>
> We spend our days issuing debt and requiring equity—both in record volume—and then we spend our evenings raising each other's eyebrows with gossip about signs of stress in the financial system.—PAUL VOLCKER.
>
> I think the Federal Reserve is going to have some difficulty over the next few years because of problems at major financial institutions.—ALAN GREENSPAN.

With the vast accumulation of debt in the American and world economies, among the most vulnerable economic actors are those who do the lending. Signs of trouble in our financial institutions abound:

On October 29, a GAO study of thrift industry problems revealed that 42 percent of all savings institutions are insolvent or have a dangerously low net worth. Most of those 1,434 institutions are not earning a profit and are, in fact, accumulating losses. The cost of liquidating the institutions is estimated at $15 billion to $20 billion and could even reach $50 billion. The thrift industry's total $1 trillion in assets balances on a true net worth of only $30 billion or so.

Commercial banks are also in deepening trouble. According to a study by Veribanc, Inc., as of June 30, 1,913 banks, or 13.3 percent of all federally insured banks, were losing money, compared with 1,514, or 10.5 percent, a year earlier. As many as 270 banks could fail within a year if they continued to lose at current rates, the study reported.

The banking industry's profitability has steadily waned for 20 years, dragged down by high operating costs, mounting losses from bad loans, and shrinking market share. In fact, according to First Manhattan Consulting Group, Inc., bank stocks sell at a bigger discount to book value than any other industry, including such troubled industries as steel and mining.

The FDIC on November 8 reported the 100th failure this year of a bank that it insured, and a spokesman said the total is likely to reach 120–125, up from 78 last year and 45 in 1983. Of the 100 failures, half have been agricultural banks, defined by the agency as those with more than 25 percent of their portfolio invested in farm loans.

The Farm Credit System, with $71 billion in loans outstanding, has indicated that a large portion of its loans may have to be written off, and has requested substantial financial assistance from government. In 1985, the system lost $2.69 billion, its first loss since the Great Depression. In 1984, by comparison, the system posted a $373 million profit.

These problems are the result of the intersection of two trends: increasing borrowing tendencies by American households and firms, and decreasing regulation of financial institutions.

The old system of bank regulation had a number of economic shortcomings, but it did demonstrate a remarkable track record in preserving the safety and soundness of financial institutions. The regulations prescribed rates of return which could be paid on deposits, and limited the kinds of lending activity which financial institutions could pursue.

Deregulation has thrust many financial institutions into uncharted, and highly competitive, waters, well described by the respected investment banker Henry Kaufman:

> With the onslaught of deregulation, financial innovation, and new technology, . . . market participants cannot avoid being caught up in debt creation. If they turn their backs on the world of securitized debt, proxy debt instruments, and floating-rate financing, then they lose market share, they fail to maximize profits and they are unable to attract and hold talented people. The driving force is credit growth, . . . and in the process, the most conservative among institutions compromise standards and engage in practices that they would not have dared to pursue a decade or two ago.—HENRY KAUFMAN, Salomon Brothers.

Traditionally, American Commercial banks could rely on large and stable deposits from corporate treasuries, but large corporations are increasingly managing their financial affairs themselves, and shrinking their deposits at banks.

This shrinking of the traditional source of funds is driving banks to find new ones, but new funds can only be attracted by paying high rates. High rates on deposits must be matched by high yields on loans, so financial institutions are driven to seek borrowers willing to pay very high interest rates. It is this relentless search for borrowers willing to pay high rates that is responsible for financial institutions' willingness to lend to profligate debtor nations, oil wildcatters, and takeover artists.

Financial institutions are also in direct conflict with securities firms for satisfying the borrowing needs of major economic actors. Barred by law from underwriting mutual funds or commercial paper, banks have been retaliating against Wall Street's incursions by offering corporate clients liquidity in the form of commitments—to make loans, to buy or sell foreign currency, or to guarantee the obligations of a creditor. Banks can charge tidy fees for making these commitments and yet not set aside capital to back them, as they would loans. At the end of 1984, these "off-balance-sheet-liabilities" at the 15 largest banks totaled $930 billion, or about 8 percent more than their assets.

Deregulation has also created new competitive pressure in the thrift sector. Many states permit savings and loans virtual *carte blanche* in making investments, and the result has been a series of spectacular investment mistakes by institutions unprepared to handle such discretion in a highly competitive environment. High-risk loan strategies underlie the crises at Financial Corporation of America in California, and the thrift crisis in both Ohio and Maryland.

Options for dealing with a large-scale problem in the financial system are limited. The GAO said that the cost of rescuing 434 insolvent institutions could be $15 billion to $20 billion. But the Federal Savings and Loan Insurance Corporation (FSLIC) now has only $2.6 billion it can use for this purpose. Federal Home Loan Bank Board officials have suggested that a means of augmenting the insurance fund would be to require the Federally insured thrifts to contribute 1 percent of their deposits to the FSLIC. But the GAO found that it would force an additional 159 thrifts into insolvency.

In recent months, the Federal Reserve has been moving toward closer supervision of financial institutions, a trend which we strongly support in light of the litany of problems in this sector. Such measures as limits on "junk bond" financing, requiring higher bank capital reserves, and developing new rules for deposit insurance, all appear to us to be steps in the right direction.

Ultimately, we are convinced that the present system of wholesale deregulation and rampant debt growth will have to be reformed. This pattern creates, in the words of Felix Rohatyn, a "ticking time bomb" in the heart of the American financial structure.

DEMAND

Over the past several years, economists and policymakers have been primarily concerned with problems of supply in the American and world economies. Slower growth in output and lagging productivity forced attention onto questions of production rather than consumption.

We believe that this emphasis has had a number of positive results, but we see a number of signs that policy may have overreacted in the direction of supply. There are a number of important signs on the horizon which point to a reemergence of demand as an important question for policymakers. It is our hope that, as we move forward in dealing with such critical issues as reducing the Federal deficit, dealing with the world debt crisis, restoring, prosperity to America's farmers, and improving American competitiveness in the world economy, we will be able to keep one eye on questions of supply and one eye on questions of demand.

TOO LITTLE DEMAND?

A brief review of the major sources of demand in the American and world economies suggests growing uneasiness about the ability of consumers to continue purchasing the output of producers.

Policies designed to fight inflation are also policies which curtail demand—high unemployment, substantial idle capacity, high interest rates, slow rates of GNP growth. Indeed, the flip side of our success in holding down inflation is that we may have inadvertently tamped demand down too far as well.

Households, the major source of demand in the American economy, have been carrying the economy forward with their purchases during much of 1985. But real wages actually declined last year, and personal income has not kept up with the growth in consumption. Consumer demand has been sustained only by piling up hugh guantities of debt.

But debt growth cannot be a long-term source of increase in consumer demand. Household incomes will need to grow in order to sustain demand growth, and the outlook for income growth is not optimistic.

In the United States, projections for 1986 indicate that wage increases will be smaller than the previous year, a continuation of a trend beginning in 1982. Real wages are expected to decline, as the projected increases will not match the projected inflation rate. This continues a trend of deterioration of real U.S. wages beginning in the 1970's.

In the other OECD countries the wage component of GNP has dropped continually since the late Seventies, in some cases to lower levels than those prevailing at the beginning of that decade. In the major seven OECD countries (excluding the United States), the rate of annual wage increases has declined more or less continually since the mid-Seventies, and are currently only slightly above the rate of inflation.

Business is another key source of demand, but there is still substantial excess capacity in most sectors and no evidence of any strong planned growth in demand for capital goods.

The *McGraw-Hill Report* stated:

> Given that the U.S. economy has been growing for three years, and continues to grow, it is surprising—*even shocking*—that the survey projects a decline in capital spending next year. (Emphasis added.)

Government, the third key component of domestic demand, will also be cutting back in the future. Regardless of the mechanism chosen to reduce the Federal deficit, there is broad recognition that deficit reduction will be a national priority. This reduction in Federal Government demand stimulus cannot be absorbed by the state and local sector, which is severely constrained in its ability to engage in deficit finance. The government sector as a whole is therefore expected to subtract from aggregate demand in the coming years.

This leaves exports as the final possible source of demand growth, and here, too, the outlook is uncertain. The world economy has come to depend to an extraordinary degree on the American market as a source of demand. European countries, still concerned about inflation, have been very slow to adopt stimulative policies.

The increasingly important economic actors of Asia, on the other hand, have adopted deliberate policies of export promotion and domestic demand restraint as a device for securing market share in the rest of the world. And the major Latin American countries are still mired in debt, unable to expand their domestic market at a rapid pace and forced by the International Monetary Fund (IMF) and other sources to practice "restraint" in the pursuit of export surpluses. The results of this combination of factors has been a dramatic erosion in America's ability to capture world export markets.

TOO MUCH SUPPLY?

All over the globe, in developed and developing nations alike, producers in a broad spectrum of industries are turning out more than consumers can buy, creating a new world economy—a glut economy.

Overabundance has replaced the chronic shortages of the 1970's. There are rising stockpiles of raw materials, underutilized and mothballed factories and vast pools of idle labor. Prices are weak or falling, not ratcheting out of control in an inflationary spiral.

And new production is coming on-line daily. South Korea and Taiwan are manufacturing color televisions. Petrochemical plants and refineries dot Saudi Arabia and other oil-producing countries. China has expanded its textile industry. Yugoslavia is preparing to export cars. Argentina has doubled its corn and wheat acreage. Brazilian shoes have become ubiquitous in North America, and its growing steel output is another constant American worry.

There are not good worldwide data on industrial capacity and operating rates. Measurement procedures and the quality of statistics vary greatly from country to country. The definition of excess capacity itself is a function of varying assumptions about prices, technology, relative costs of capital, materials and labor, and other factors.

But Edward Denison, a Brookings Institution economist who studies growth, estimates that this country has "the largest reserve of unused production capacity since the Thirties."

Capacity utilization rates in Japan, Germany, and Canada also show a similar pattern. From a 79/80 peak, utilization in Germany has dropped from 86.0 percent to a current level of 82.8 percent, while during the same period, Canadian utilization rates dropped from 86.6 percent to 76.0 percent. In Japan, where utilization is calculated as a percent of a historical peak, utilization rates dropped from 91.6 to 85.0 percent during the same period.

But in spite of this evidence of excess capacity, many countries are bringing new facilities on-line. Many LDC's have increased their productive capability, as export-oriented growth drives were adopted, often at the behest of Western aid donors, and import substitution policies were followed to capture the home market and reduce the siphoning off of foreign exchange for consumer goods. As a result, the most commercially aggressive developing countries not only need fewer goods from the Western world, but are increasingly themselves becoming major exporters of manufactured goods.

For example, Brazil is becoming a net exporter of automobiles and commuter aircraft; Mexico is developing as a center for auto engine production; and Korea has unleashed a Japanese-style export drive on U.S. and Canadian markets.

PRICES

The combination of slow growth in markets and expanding productive capability has generated stubborn downward pressure on prices. The following table shows how prices for crude, intermediate, and finished goods have not responded to economic recoveries as they have in the past. The table traces price movements from the troughs of the last two recessions to an equal number of months into the next recovery.

TABLE 4.—CHANGES IN U.S. PRODUCER PRICES DURING THE LAST 2 RECOVERIES

	Percent change March 1975 to January 1978	Percent change November 1982 to September 1985
Crude materials	+17.8	−7.9
Crude nonfood materials	+27.0	−5.1
Crude nonfood materials, less energy	+17.7	+6.9

TABLE 4.—CHANGES IN U.S. PRODUCER PRICES DURING THE LAST 2 RECOVERIES—Continued

	Percent change March 1975 to January 1978	Percent change November 1982 to September 1985
Intermediate goods	+16.5	+2.2
Finished goods	+18.3	+2.5

Source: Calculated from data provided by the Bureau of Labor Statistics, Oct. 25, 1985.

The Labor Department reported on October 11 that the prices of crude goods, measured in the Producer Price Index, dropped for the tenth consecutive month. Prices of sensitive materials have dropped for 15 straight months, according to the Commerce Department. This slide in commodity prices lies behind the bad loan problems of lenders to the energy and mining sectors, as well as banks with loans to third world countries that export commodities. Similarly, sliding prices for farm commodities are reflected in the huge decline in farmland prices, and the crisis in American farming.

One consequence of this slide in prices is, perversely, an *increase* in production. Many commodity-producing countries are so strapped for dollars that they will produce even if it is uneconomic to do so. Because of price declines, producers have an incentive to increase production still further in an effort to make up per unit price declines by increases in volume. For example, producers of oil, such as Great Britain, Norway, and the Soviet Union, have been increasing production in an effort to increase their oil market share. This is partially responsible for the countermove by the Organization of Petroleum Exporting Countries (OPEC) and today's oil price war.

Other commodity producers are experiencing similar difficulties. Sugar producers have been unsuccessful in supporting world sugar prices. The International Cocoa Agreement recently ran out of money to support prices through open market purchases. The International Rubber Agreement buffer stock is full, at 375,000 metric tons of rubber purchased at a price of $300 million, and prices are still close to the bottom of the target range. The tin market has recently collapsed as a result of the cartel's inability to support prices under conditions of oversupply. And in our own dairy sector, falling prices are leading many farmers to increase their production.

THE PETROCHEMICAL INDUSTRY

Global consumption of chemical products began to drop in 1980, as the result of substitution of other products for petrochemicals, and the saturation of markets for two main products, polyvinyl chloride (PVC) and low density polyethylene. The imbalance between supply and demand became worse in 1982, and has led to low capacity utilization, price cutting, and reduced per unit profits.

Although producers in the United States, Europe, and Japan have begun to prune excess capacity, production increases elsewhere threaten to accelerate the financial crisis of the industry. Major new refineries of petrochemicals are being added in the Middle East, North Africa, and Canada. Capacity in the Middle East and North Africa could reach 2.4 million tons per year of ethylene, up from about 50,000 tons in the mid-1970's, a 48-fold increase. If all planned production facilities are completed, production could reach 3.4 million tons in 1990, a 68-fold increase. Capacity in Canada is also expanding greatly, and will increase to 3–3.7 million tons by 1990. Canadian demand growth for ethylene is not expected to exceed 2.5 percent, which will result in 1.3 million tons of exportable ethylene equivalent by 1990, most of which will be targeted for the United States, Japan, and Asian countries.

Import-substitution policies have also led to significant increases in production in Latin America and Asia. Brazil plans to add 250,000 tons of ethylene capacity by 1990, and a plant recently opened in Mexico which will double capacity to almost one million tons. In Asia, plants are planned or being built in Singapore, Thailand, Malaysia, Indonesia, and the Philippines. According to official plans, the centrally planned economies also plan to add about three million tons by the end of 1985.

Chemical investment in France has risen 30 percent during the past three years, and Atochem, Rhone-Poulenc, and CdF Chimie have revamped petrochemical plants slated to come back onstream this year. While the government grants that allowed Rhone-Poulenc to invest heavily in 1982–1984 have dried up, the company expects a small profit rise for 1985 to about $270 million.

THE STEEL INDUSTRY

Demand for steel products in OECD countries increased in 1984, but is expected to decrease again in 1985. This is a continuation of a trend of declining consumption that began in 1973. OECD capacity utilization increased to 70 percent in 1984, and is expected to remain there through 1985. In 1985, total world production is estimated to have increased by only 1 percent over 1984 levels. In order for capacity utilization to reach 83.5 percent, which was the 1960–1972 average, a reduction in productive capacity of 70 million tons would be needed. These current utilization rates are obtained even though capacities have been cut back by 17 percent in both the United States and the European Economic Community (EEC) from respective peak years of 1977 and 1979. The remaining OECD countries show a decrease of only 2 percent from a peak in 1980.

These cutbacks in the industrialized countries have been met by capacity increases in the remaining Western world. Production in Brazil, for example, increased 25 percent, and production in developing countries as a group increased 11 percent in 1984.

In the United States, one response to overcapacity has been the rise of small, high technology mini-mills. While consumption has been falling since the late 1970's, capacity has been increasing. For example, while domestic consumptions of rod and bar steel has dropped 20 percent from 1978, capacity has risen 44 percent in the same period. As a result of overcapacity, prices have been dropping and a number of mills have gone bankrupt in 1985, including Marathon Steel Company in Tempe, Arizona; Soule Steel Company, in Carson, California; and Kentucky Electric Steel Corporation in Ashland, Kentucky.

REAL ESTATE

The 1981 tax law revisions have had a major stimulative effect on the construction of commercial real estate, especially office buildings and shopping centers. But as with many tax incentives, the effects of the 1981 changes have been heavily "front-loaded." Rapid expansion of commercial real estate in response to these tax incentives has created a huge reserve of empty office space in many of the Nation's major markets.

Office vacancies are at a record national average of 16.5 percent in downtowns and 21.5 percent in the suburbs. Some of this huge overhang has been precipitated by builder anxieties about tax reform, and a number of contractors have accelerated future projects in order to get them in place before Congress rewrites the tax laws.

SHIPPING

The shipping industry is in the most severe slump since the Depression. Great expansion of shipping throughout the Seventies has led to a huge imbalance between supply and demand. While total world trade shipping tonnage has grown by 32 percent since 1970, the capacity of the world merchant fleet has increased by more than 100 percent.

This has led to a total oversupply of tankers of 106 million tons, equivalent to 500 supertankers. Approximately one-quarter of dry bulk vessels worldwide are drydocked. Prices of some types of ocean freight are less than one-third the level of five years ago, and the resale value for some ships has been as low as 5 percent of their construction price.

In order to maintain sales, South Korea, the world's most efficient producer, has priced its output far below the price of materials.

Declining profits for large shipping companies has led to the bankruptcy of a number of large concerns. Sanko Steamship Company, one of the world's largest operators of oil tankers, began bankruptcy proceedings in August as a result of outstanding debts of about $2.2 billion.

HIGH TECHNOLOGY INDUSTRIES

There is evidence that industries still experiencing rapid innovation—such as the microelectronic industry—are also subject to the destabilizing influence of global overcapacity.

The mass production of computer chip technologies, coupled with a slowdown in market growth, is already leading to an unprecedented shakeout of the previously health computer industry. Worldwide demand for computer chips is estimated at present to be only 40 percent of capacity.

The Ryavec Corporation estimates that Japanese producers have stockpiles of over 93 million memory chips. This is quadruple the amount a year ago, and equals three months of U.S. consumption.

As a result of overcapacity, prices of some semiconductor products have dropped by 90 percent in less than a year. Despite a global glut, Japanese semiconductor firms plan additional expansions of capacity.

Other areas of high-tech industries are experiencing similar gluts. The output of the top four of the 35 manufacturers of floppy-disk drives could satisfy world demand.

Finally, since much of the high-tech boom in the United States is due to the defense buildup, the overcapacity problems will worsen when deficit-cutting efforts finally reach the defense industry.

FARMING

Perhaps the most significant imbalance between supply and demand is in agriculture. The recently passed farm bill was designed to rescue American agriculture from the doldrums through a "supply-side" miracle of falling prices to recapture export markets for American goods. A brief review of the world agriculture situation suggests that such an approach may well fail.

In the 1970's, exports seemed the key to American farm prosperity. Other countries were rapidly improving their diets, and agriculture around the world was not nearly as productive as American farming. We seemed poised for rapid growth in agricultural production and export sales.

But this rosy future did not materialize. The recession of the early 1980's cut deeply into incomes (and consumption) abroad. Worldwide grain and soybean exports, which had expanded rapidly for two decades, have stagnated in the 1980's. In the 1980's, world grain exports have grown more slowly than total world consumption, the reverse of the 1960's and 1970's, as countries turned increasingly to their own farmers to meet their demands. For example, world corn consumption climbed 36 percent in the 1970's, while trade grew 71 percent. In 1986, total corn exports are expected to be 4 percent lower than in 1981, while world consumption is only 10 percent higher.

These changing conditions precipitated an export collapse which lies at the center of today's farm crisis. From a historic peak of $43.8 billion and 162 million tons in 1981, our overseas farm sales are projected to drop to $29 billion and 120.5 million tons this year. Other countries—Argentina, Australia, Brazil, Canada—took advantage and raised their share of global exports. Since 1981, U.S. wheat exports have fallen from 44 percent to 36 percent of the world total.

But loan obligations by American farmers have forced them to continue to expand production even in the face of this export collapse. A predicted bumper harvest this year will also expand supply and depress prices further. Near record wheat crops in the United States are currently being stored under price-support programs.

There is a worldwide cotton glut, and the U.S. cotton surplus could double in 1986.

And while we have been struggling to increase supply, other countries have substantially increased their own agricultural production, dramatically cutting world demand for food. In the People's Republic of China, food output is up an unprecedented 40 percent in the last five years. Once the importer of four million bales of cotton a year, China now exports one million bales. Even with bad weather, the Chinese may export five million tons of corn this year. India, once thought of as the world's worst food case, has doubled its wheat production since 1970 and now is trying to sell its surpluses abroad. Its rice production is also up more than 30 percent.

In the European Community, wheat yields are up 23 percent in 1984—mainly because of a new seed. Indonesia has become self-sufficient in rice from its role as a major importer. Japan, Taiwan, and the Philippines are trying to cope with rice surpluses. New hybrid seeds are pushing the Corn Belt 250 miles north—a development of major import to farmers in Europe, the Orient, and the Soviet Union, not to mention the United States.

Between 1971 and 1982, world agricultural output rose 25 percent and the output in the LDC's was up 33 percent (it was only 18 percent in the developed countries). Per capita food production went up 16 percent in South America and 10 percent in Asia during that time.

Taken together, these trends produce a dramatic imbalance between supply and demand in agriculture, as revealed in the following table:

TABLE 5.—WORLD SUPPLY AND DEMAND FOR AGRICULTURAL COMMODITIES[1]

	1983-84	1984-85	1985-86
Total grains:			
Production	1,483.97	1,641.48	1,667.45
Consumption	1,552.12	1,593.97	1,602.57
Ending stocks	184.17	231.69	296.56
Stocks/consumption (percent)	11.87	14.54	18.50
Wheat:			
Production	490.98	513.86	505.20
Consumption	486.63	500.59	494.23
Ending stocks	100.82	114.09	125.07
Stocks/consumption (percent)	20.72	22.79	25.31
Rice:			
Production	307.70	319.29	317.26
Consumption	307.799	315.509	315.257
Ending stocks	17.23	21.02	23.02
Stocks/consumption (percent)	5.60	6.66	7.30
Coarse grains:			
Production	685.28	808.32	844.99
Consumption	757.69	777.87	793.09
Ending stocks	66.12	96.58	148.48
Stocks/consumption (percent)	8.73	12.42	18.72
Corn:			
Production	345.72	454.62	474.58
Consumption	409.14	433.88	433.01
Ending stocks	32.99	53.73	95.30
Stocks/consumption (percent)	8.06	12.38	22.01
Soybeans:			
Production	82.56	91.12	98.78
Consumption	85.84	88.05	89.87
Ending stocks	13.25	16.41	24.98
Stocks/consumption (percent)	15.44	18.64	27.80
Cotton:			
Production	67.61	87.24	81.12
Consumption	68.93	69.12	72.09
Ending stocks	24.66	42.25	51.19

TABLE 5.—WORLD SUPPLY AND DEMAND FOR AGRICULTURAL COMMODITIES[1]—Continued

	1983-84	1984-85	1985-86
Stocks/consumption (percent)	35.78	61.13	71.00

[1] In million metric tons, except percent; and cotton, where units = 480 lb bales. 1984-85 are U.S. Department of Agriculture (USDA) estimates; 1985-86 are USDA projections as of Dec. 10, 1985.

In light of these statistics, it appears that there may be little hope in resolving the problems of American farmers if our farm policy is based on expanding supply and capturing new world markets.

DEALING WITH THE DEMAND PROBLEM

The data suggest a looming potential problem of demand in both the American and world economies. And the dynamics of contemporary economic relations hold no guarantee that such problems can be avoided.

Given the decentralized nature of investment decisions, excess capacity may be perpetuated in the face of sluggish demand. Even state-supported producers make decisions on capacity expansion on the basis of their competitiveness in their particular market, with little attention paid to productive capabilities of that industry on a global level. Thus, the Canadian government is helping to reopen a British Columbia copper mine, with full production scheduled for September. The government of the Philippines has purchased a low-grade nickel mine, subsequently increasing production.

The policies of the centrally planned economies can also accelerate the trend toward overcapacity. The need for hard currency to finance imports from the West provides the incentive for such countries to develop production capabilities for export to Western markets. The recent entry of Yugoslavia into the automobile market and the imminent entry of the Soviet Union into the low-priced auto business are cases in point.

Overcapacity is also stimulated by the desires of countries providing markets to have production facilities relocated in the host market. This leads to, for example, continual increases in Japanese manufacturing in the United States, which is good for U.S. jobs, but which also increases productive capacity worldwide.

We believe that the problems of demand are manageable, but that a serious problem could emerge if attention is not paid to the demand side of the economic equation in the design of economic policies. We shall return to the specifics of what it means to pay attention to "the demand side" in later sections of this report dealing with American fiscal and monetary policy, wage and productivity policy, international macroeconomic policy, and the world debt situation.

FAMILY INCOME AND LIVING STANDARDS

> For the last 11 years, the American economy has been in a quiet depression in which neither wages nor family incomes have grown.—FRANK LEVY, RICHARD MICHEL.

There is no more obvious measure of the success or failure of an economy than its ability to deliver a rising standard of living to all of its citizens. By this standard, the American economy is performing very badly indeed.

In the American economy, the principal source of income is a job. Transfer payments and capital income provide important supplements to wage income, but for the vast majority of Americans, their individual prosperity depends on their ability to earn a decent income in the labor market.

Over the past decade, and continuing into the present, the American economy has been doing a very poor job of generating good earnings opportunities for American workers. The economy has managed to create a large number of jobs, but the incomes associated with those jobs have not kept pace with our expectations. Reversing this trend needs to be a major goal of future economic policy.

The 1949-1959 decade was characterized by moderate economic growth. The average income of all persons (as measured by real per capita disposable income) rose in all but two years, achieving an annual real growth rate of 2.0 percent. During the 1960's and early 1970's, economic growth accelerated. Between 1959 and 1973, there were 14 consecutive years of growth in real disposable income per capita, averaging 3.6 percent per year.

The high rates of growth of the 1960's and early 1970's have not been sustained, however. During the 11 years from 1973 to 1984, real disposable income per capita dropped in three years—1974, 1980, and 1982. The annual rate of real growth since 1973 declined to 1.9 percent, just a little more than half the growth rate of the 1959-1973 period.

The central factor behind this stagnation in incomes is the stagnation in wages.

As these two charts suggest, overall national income is rising slowly, but the share of national income going to wages and salaries is declining.

Figure 16

REAL AVERAGE WEEKLY EARNINGS

in 1977 dollars

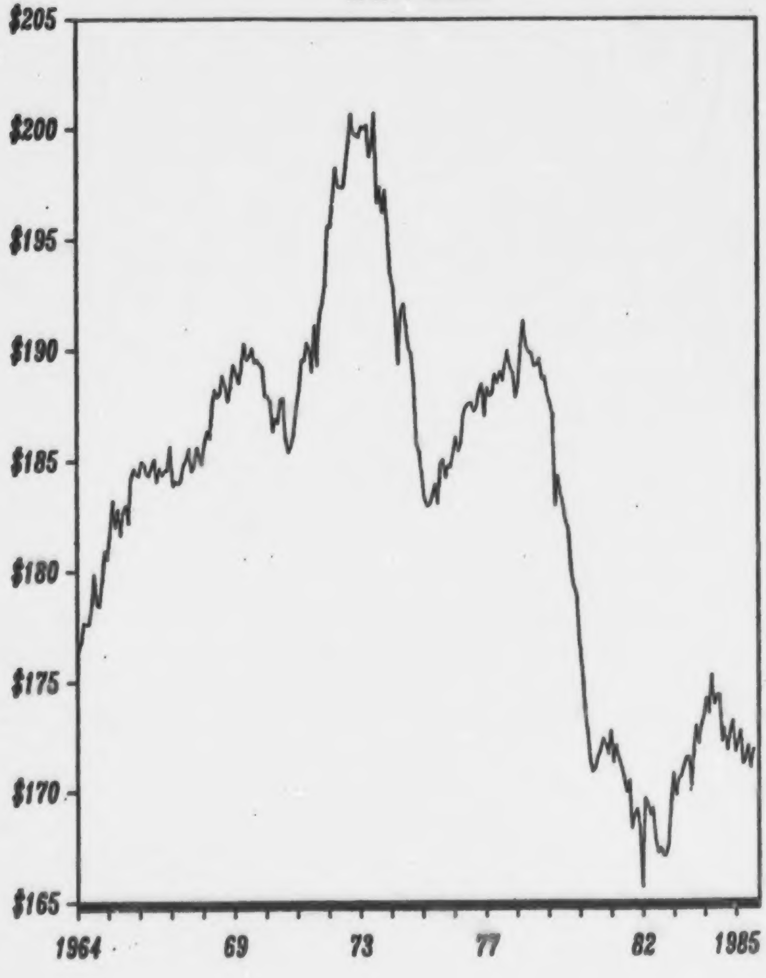
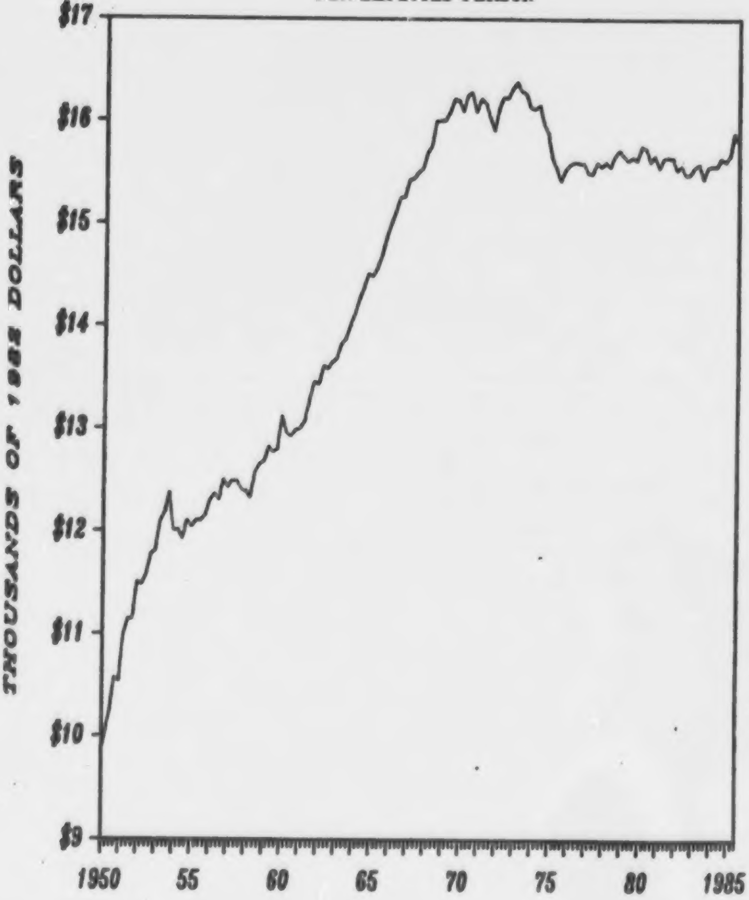


Figure 17

REAL WAGE AND SALARY INCOME

PER EMPLOYED PERSON



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Correcting for inflation, between 1976 and 1984, real earnings have fallen 9.3 percent for men and risen 5.3 percent for women. Yet, over the same period, the real per capita GNP rose 16.3 percent. The income share going to workers is falling, with total labor compensation down to 54.6 percent of GNP in 1984 from 56.2 percent in 1976.

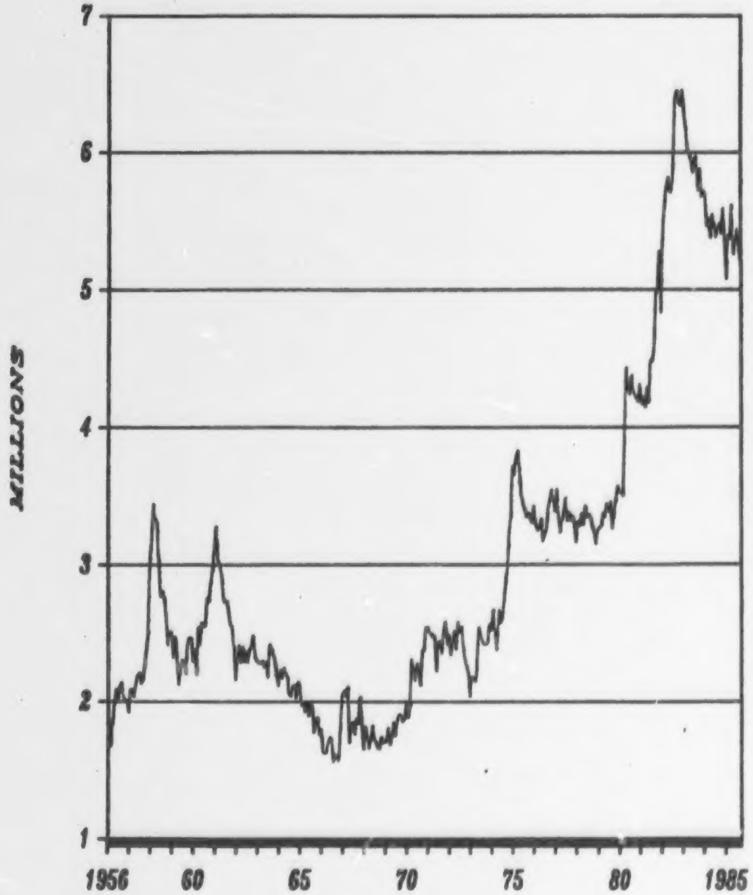
And present trends show no sign of a turnaround. Despite the current economic recovery, hourly earnings rose by 3.0 percent last year, less than the increase in the cost of living.

There are a number of reasons for the stagnation in wages. The first is demographic. The American labor market absorbed an unprecedented number of new workers as the "baby boom" generation came of age and many more women sought to enter the work force. At the same time, productivity in the American economy stagnated (see Figure 12). With stagnant productivity, new workers could only be absorbed by a reduction in average wages.

Another reason is rising unemployment (see Figure 11). But rising unemployment alone is only a part of the answer. Another key development is a shift in the labor market toward part-time work. As Figure 18 shows, the number of people forced to take part-time work "for economic reasons" (i.e., they could not find full-time work) has risen dramatically in recent years.

Figure 18

INVOLUNTARY PART TIME WORKERS



Another factor is the declining ability of unions to negotiate wage increases for their members. Unions were once a major source of wage growth in the American economy, but under heavy pressure from high unemployment and a climate hostile to worker organization, the union movement has found itself unable even to defend gains won in the past, much less press forward with new settlements for wage growth. Last year, the employment cost index for unionized firms rose by only 2.6 percent, well below the 4.6 percent for nonunionized firms. It is significant that, although the unemployment rate has declined, there has been no pronounced upturn in wages for either unionized or nonunionized firms. Normally, a decline in unemployment is matched by a rise in the pace of wage increases. The failure of this pattern to emerge now suggests that wage growth could well remain low over the next few years.

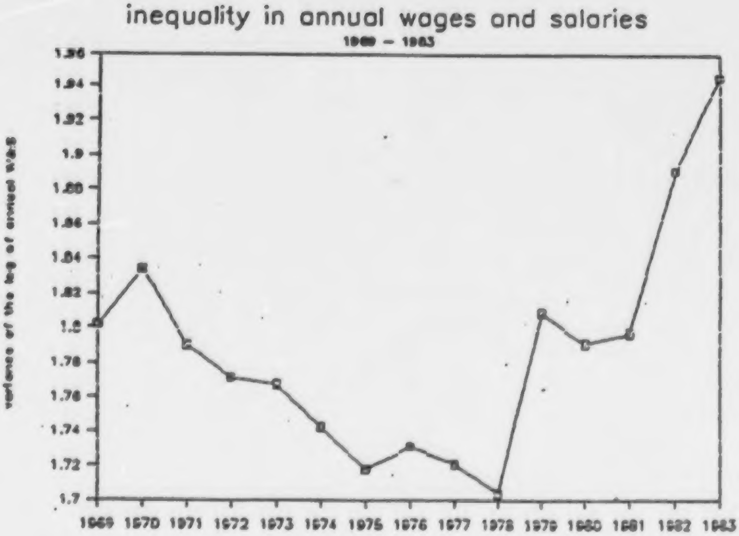
Another contributing factor in the erosion of wages is international competition. The share of trade in GNP more than doubled in the last 15 years, and more and more workers found themselves in competition with very low-wage workers overseas. Many firms have reacted to competitive pressures by demanding wage concessions from their workers, attempting to break up worker organizations, and developing such innovations as "two-tier" wage agreements as a device for holding down labor costs.

The effects of our deteriorating trade balance appear quite directly in the earnings of American workers. Firms producing products which are traded internationally tend to pay better wages than those producing goods or services used entirely in the domestic market. While median earnings for the entire economy were $16,168 in 1983, export industries were generating median earnings of $18,637 and import-competing industries had median earnings of $19,583. As a result, when imports rise and exports fall, as they have in the last five years, wages tend to fall in the traded-goods sector, and this exerts a downward pressure on average wages in the economy.

INCREASING INEQUALITY

Alongside the stagnation in wages, signs are developing of increasing inequality in the earnings opportunities available to American workers. Recent research by Professor Bennett Harrison of MIT documents a significantly growing level of inequality in the earnings of American workers (see Figure 19). The inequality revealed in this chart remains even if the data are corrected for the influence of demographic and business-cycle factors.

Figure 19



Other data support this general conclusion:

Between 1958 and 1977, wage polarization grew dramatically. The wages of the bottom 20 percent of the work force grew by 130.6 percent, while those in the top fifth grew by 206.7 percent.

From 1976 to 1984, the number of middle-income male jobs (jobs paying between 75 percent and 125 percent of median male earnings—$12,769 to $21,282 in 1984) declined from 23.4 percent to 19.7 percent of the male work force. The trend continues during the current recovery. In a boom year, 1983, the total number of males with earnings rose by 500,000, one-half million, but the number of males with middle-income earnings fell by 500,000. In 1984, the total number of male earners rose by 216,000, but the number of middle-income earners fell by 197,000.

The connection between these earnings statistics and the structural transformation of the economic base of our society is revealed in a recent unpublished study by the Bureau of Labor Statistics which looked at the fastest growing and fastest declining industries. Of the 20 fastest growers, only three were in manufacturing, while the ranks of the decliners were dominated by manufacturing (14 of the 20). The fastest growing industries paid average wages of $210 per week, while the decliners paid an average of $310. This translates into an annual earnings gap of over $5,000. In other words, if a worker lost a job in the declining manufacturing sector and found a new one in the emerging service sector, that worker would typically also probably suffer an earnings loss of $5,000 per year, a drop of nearly 25 percent.

THE WORKING POOR

One of the major negative consequences of a labor market which fails to provide decent earnings opportunities is a dramatic increase in the phenomenon of "working poverty."

For a growing number of American workers, even a full-time, year-round job is insufficient to raise them and their families out of poverty. In 1984, about one-fifith of husbands heading two-parent families and two-thirds of women heading single-parent families earned less than $204 per week. Such persons could not earn the yearly poverty-line income for a family of four even if they worked 52 weeks a year at their current weekly wage. The incidence of this type of working poverty among families with children increased from 20.8 to 29.9 percent between 1967 and 1984, rising more rapidly than did the overall rate of poverty.

Other statistics tell the same story:

The number of prime working-age individuals (those persons aged 22 to 64) who work but are still poor has soared, increasing by more than 60 percent since 1978.

Of all poor persons who head families, nearly half (49.2 percent) now work at some point during the year.

The number of persons who work full time year-round and are still poor now stands at over two million, an increase of more than two-thirds since 1978.

The increase in working poverty is directly related to the deteriorating overall employment situation, but it also reflects a stagnation in economic policies which formerly had served to increase the earnings of those at the bottom of the labor market.

The minimum wage has not been adjusted in nearly five years—since January 1981—while inflation has raised consumer prices nearly 25 percent during this period. In other words, the minimum wage now provides a standard of living nearly 25 percent lower than it did in January 1981.

Families with only one wage earner, working at the minimum wage, are now almost certain to be poor. In 1978, a family of four with one person working full time year-round at the minimum wage fell $1,150 below the poverty line. In 1978, a family of three with a full-time minimum wage earner was above the poverty line. Today, this family is $1,600 below the poverty line. And in 1978, a family of two (a parent and a child) wiht a full-time minimum wage-earner was $1,300 above the poverty line. Today, this family, too, falls into poverty.

Even a family of four with two wage earners—one working full-time at the minimum wage an one working half-time at the minimum wage—is now poor.

This a particular problem for female heads of households. Single-parent families are usually limited to one earner, and women occupy a disproportionate share of minimum wage and other low-paying jobs. Families headed by females have a poverty rate six times that of families headed by males. If wives and female heads of households were paid the wages that similarly qualified men earn, much of our nation's poverty problem, could be overcome.

FAMILY INCOME

Trends toward wage stagnation and increased inequality in earnings are starting to affect the standards of living of American families as well. Both the growth and distribution of family income tend to be more stable than individual earnings, because families have many devices for coping with the labor-market problems of their members. If one family member suffers a significant earnings loss, sthat income can often be replaced by sending other family members into the labor market. But while such mechanisms protect the family's purchasing power, in many cases, such "forced labor" significantly diminishes their quality of life.

According to a recent study for the Committee, the median after-inflation income of American families has fallen steadily throughout the last decade. In 1973, median family income was $28,167 (in 1984 dollars). In 1984, the median was only $26,433.

And along with stagnation in earnings growth came the same increase in inequality noted in wages:

According to the Census Bureau, the gap between the income of the richest American families and the poorest has widened in recent years, and now stands at its highest point since they began keeping statistics in 1946.

The Census Bureau reports that the lowest 40 percent of the income distribution had 20 percent of the family income in 1967; by 1984, it had only 15.7 percent of the national income, the smallest share since 1947. Such families had $470 less in real income in 1984 than in 1980.

Families in the middle lost as well. The 20 percent of families with incomes in the middle of the income scale received 17 percent of the national income last year, their lowest share since 1947.

At the same time, the wealthiest 40 percent of U.S. families received 67.3 percent of the national income, their largest share since 1947. The median family in the top 40 percent had $1,800 more in income than in 1980—and the median family in the richest 10 percent of the population had $5,000 more in income than in 1980.

If the shares of national income had been the same in 1984 as in 1980, the poorest fifth of all families would have received $8 billion more in income. The wealthiest fifth would have received $25 billion less.

Using Federal Reserve Board definitions of income (which include capital income often excluded from Census data), the share of total income going to the top 10 percent of all families has risen from 29 percent in 1969 to 33 percent in 1982.

And the distribution of income is even more unequal for families with children:

Between 1967 and 1984, the share of national income going to the lowest quintile of families with children declined 34.3 percent, from $9,347 to $6,142. Over the same period, the mean income of the highest quintile increased from $54,665 to $62,198. A typical family in the second quintile lost 13 percent ($18,950 to $16,491) while one in the fourth quintile gained 11.1 percent ($33,276 to $36,967).

This trend toward growing income inequality has also been noted by retail marketers, whose business involves knowing who has earnings. In a recent *Fortune* magazine article, a vice president for marketing at Bloomingdales noted: "In the Seventies it became apparent that the profitable markets would be at the top and the bottom of the scale, because of restrictions on the middle of the market." Her views were supported by marketing executives from both General Electric and Pillsbury, one of whom termed the shift toward a more polarized incomes distribution "irreversible."

If there were just one number pointing toward more inequality, it could be ignored as a statistical fluke. Given the wide variety of data, all of which point in the same direction, there can be little doubt that what is happening is a real event.

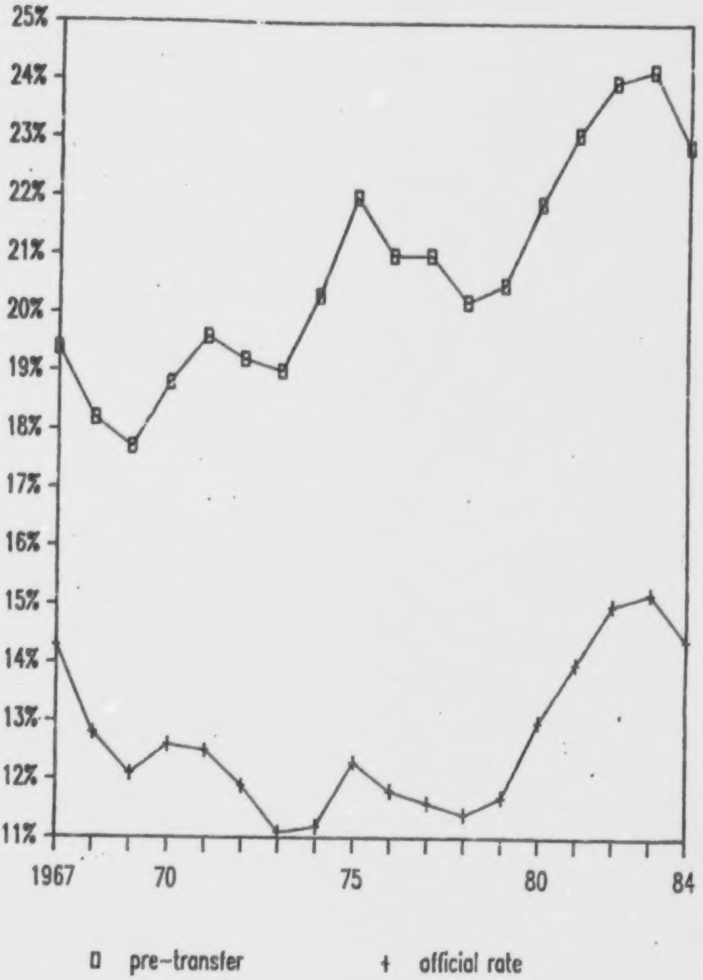
POVERTY

The twin problems of stagnating overall family incomes and a worsening of the income distribution show up most dramatically in the statistics on poverty. The following chart supports the observation of the National Commission on Employment Policy that:

> Almost all of the substantial progress against poverty in this country over the past 20 years can be accounted for by improvements in our transfer system.—NATIONAL COMMISSION ON EMPLOYMENT POLICY.

Figure 20

POVERTY RATES



The chart also illustrates a second point: the effectiveness of transfers in reducing poverty has decreased in recent years—transfers removed 70 percent of the pretransfer poor from poverty in 1976, but less than 65 percent in 1982. This also means that the "poverty deficit"—the dollars it would take to lift all the poor from poverty—has been increasing steadily, both absolutely and as a percent of GNP. We now have a larger "poverty deficit," both absolutely and relatively, than we had at the start of the War on Poverty.

Last year's drop in the poverty rate was largely attributable to reductions in unemployment. The unemployment rate dropped from 9.6 percent in 1983 to 7.5 percent in 1984, the largest single-year drop in recent decades. Given this large reduction in unemployment, the reduction in the poverty rate to only 14.4 percent is disappointing.

The poverty rate now appears to be substantially higher than it should be relative to the unemployment rate. In 1976 and 1977—when the unemployment rate was at levels comparable to the unemployment level for 1984—the poverty rate was 11.6 percent to 11.8 percent. Now, although unemployment is down to 1976-1977 levels, the poverty rate is nearly three percentage points higher than it was in those years. Had the poverty rate followed the unemployment rate back to 1976-1977 levels, six million fewer Americans would be poor today.

This statistic points clearly to the fact that poverty is a problem of the *economy*, not a problem of the welfare system which provides people inadequate income support when they lose their place in the occupational structure.

Poverty is a particular problem among children, especially young children. Poverty rates among children have soured in recent years. Children are now far more likely to be poor than adults are. Fifteen years ago, the child poverty rate stood at 13.8 percent. Today, the child poverty rate has climbed to 21.3 percent. Over 13.4 million children now are poor. For the most vulnerable children—those under the age of six—the poverty rate is even higher. Almost one-quarter (24 percent) of all children under six live in poverty.

The highest povery rates, however, are those for children who are black or Hispanic and who are also very young. In 1984, more than half (51.1 percent) of all black children under six lived in poverty.

DIMINISHED OPPORTUNITY FOR THE YOUNG

These statistics on individual earnings and family incomes suggest a dangerous drift toward income stagnation and rising inequality. While these trends cause substantial hardship for all families, they are especially hard on the young. The inability of the economy to generate rising incomes dramatically erodes the ability of young families to pursue the conventional American dream: a home, financial security, and education for their children. Today's growing inequality, of *condition* for most workers also raises the prospect of growing inequality of *opportunity* for the next generation.

The young suffer most from these trends because they have not yet made a place for themselves in the economic stucture. It is the young who will pay the greatest price if we fail to get the economy growing as fast it did for their parents.

In 1973, the average 30-year-old man earned $23,580 in 1984 dollars. By 1983, this average had dropped to $17,520. A young man leaving home in the 1950's and 1960's could expect by age 30 to be making 33 percent more than his father did when that young man left home. Today's 30-year-old males on average are making 10 percent less than their fathers were making when those 30-year-olds left home. And they are not experiencing the kind of vigorous earnings growth during the early part of their work lives that previous generations enjoyed.

As recently as the mid-1950's, the average fully employed man in his early 20's earned 73 percent as much as the average fully employed man 45–54. But by 1983, that ratio had dropped to a mere 50 percent.

Prior to 1973, the average man passing through the early earning years (where a place in the labor market gets established) saw his earnings rise by about 110 percent, but men who were 25 in 1973 saw their earnings over the next decade grow by only 16 percent.

Younger families are attempting to keep alive the possibility of achieving the American dream, but largely through adding another worker to the household. One income was sufficient to purchase a middle-class standard of living in the 1950's, but today it takes two incomes just to make ends meet. Among 25–34 year old married couples 47 percent of the wives worked in 1973. Today, two-thirds of all young wives are working. This greater proportion of workers helped prop up incomes.

And while it has become harder and harder for young families to get established in the occupational structure and experience a significant growth in their income, the costs of basic necessities have been steadily climbing out of reach.

One big reason is the doubling of home prices since 1970. In the 1950's a 30-year-old male of average income spent roughly 14 percent of his gross income on the mortgage. By 1984, that figure had more than tripled, reaching 44 percent. In 1983, more than 65 percent of first-time home buyers needed two incomes to meet their monthly payments. If these trends continue, projections suggest that fewer than one-half of all Americans under the age of 30 will ever enjoy the privilege of owning their own home.

Housing is not the only factor driving down living standards for younger families. Large educational debt burdens as well as increased energy and transportation costs all limit the living standards of the young. According to the Census Bureau, in 1983, less than a third of all households headed by a person under 35 had discretionary income.

Squeezed by stagnant incomes and rising prices for basic necessities, young families are losing the ability to be able to put away any savings to provide income security in the event of misfortune. Young families in 1983 saved less than 1 percent of their after-tax income, contrasted with 4 percent for similar young families in 1973. A recent Federal Reserve Board survey indicated the percent of young families holding *any* liquid assets in 1983 had declined from 93 percent to 87 percent relative to a separate survey taken in 1979.

These strains on younger families are showing up in statistics on family formation. Since 1973, the median age at first marriage has increased from 21 years to 22.8 years for women and from 23.2 years to 25.4 years for men, the highest levels they have reached since the early 1900's. And since 1973, the average number of children in young families (age 25 to 34) has dropped by a remarkable 27 percent.

When two wages do not seem to bring a family the same standard of living one wage did 15 years ago, when young couples cannot afford their first home, or their first child, and when 55 percent of children living in single-parent families are being brought up in poverty, it is no wonder that this generation seems to some to be materialistic. If they appear to be materialistic, it is because they are being squeezed so hard on basic material questions. Our task is to broaden both their opportunities and their field of vision.

We believe that a paper presented at our 40th Anniversary Symposium provides a good summary of the problems outlined in this section:

> The sense of relative deprivation, frustrated expectations, falling behind, being badly paid, having trouble catching up to one's parents—this is becoming a common experience of a growing number of Americans. They are white as well as persons of color. They are men as well as women. And even having a full-time year-round job is not longer a guarantee of being sheltered from this experience.—BENNETT HARRISON, BARRY BLUESTONE.

IV. THE DEFICIT AND FISCAL POLICY

Clearly, the major challenge to economic policy is the task of reducing the huge Federal deficit. Over the past five years, the Federal debt has more than doubled, and this huge accumulation of debt has put extraordinary strains on both the American and world financial systems. Getting our fiscal house in order is thus the top priority of economic policy in the coming year. But we also believe that deficit reduction should be accomplished in a manner which does not jeopardize the health of the economy or compromise our ability to achieve maximum growth without inflation.

Deficit reduction has been thrust into first place on the country's list of priorities by the passage last year of the Balanced Budget and Emergency Deficit Control Act, popularly known as Gramm-Rudman. Gramm-Rudman was passed because some saw it as an opportunity to continue the process of eliminating the role of government as a mediator in society and the economy. By reducing nondefense discretionary spending from 5.8 percent of GNP to 4.1 percent (below the 4.2 percent level of 1962, which prevailed before any Great Society spending program was enacted), many sought to turn the clock back further, by rolling back domestic discretionary activities to pre-New Deal levels.

Others supported Gramm-Rudman because they say in it a way to force the White House and Congress to agree finally on the

Grand Compromise on revenue and spending issues which is necessary to make progress in finally getting the deficit under control.

In any case, the passage of Gramm-Rudman establishes deficit reduction as a primary goal of fiscal policy and prescribes a schedule and a timetable for deficit reduction. For Fiscal Year 1987, the target is a deficit of $144 billion, a target which we believe is realistic and attainable. Falling oil prices improve the economic prospects for the coming year, and should make it psosible to accomplish significant deficit reduction without jeopardizing the economic recovery.

For the coming year, the Congressional Budget Office (CBO) projects real GNP growth of 3.2 percent, interest rates of 6.8 percent, and an unemployment rate of 7.8 percent, all of which are estimated to produce a "baseline" deficit of $181 billion. Such a baseline would require new policy initiatives totaling $37 billion in deficit reduction to reach the targets established by Gramm-Rudman. However, because of some technical problems in assembling such a baseline, this estimate may be on the low side. The $37 billion could well turn into $50 billion if revisions to the baseline must be made.

We believe the deficit reductions of this magnitude can be accomplished in the macroeconomic environment which we see developing in 1986. A principal reason for optimism is that we believe the Federal Reserve could easily adjust monetary policy to compensate for the loss of a moderate amount of fiscal stimulus. There was a substantial consensus among the economists at the 40th Anniversity Symposium that deficit reduction this year in the range of $40 to $50 billion could probably be offset with monetary policy with little damage to the economy, but greater reductions (in the $60 billion range) probably are beyond the ability of monetary policy to accommodate.

Therefore, it sems clear that near-term conditions in the American economy should make it possile for Congress and the President to make significant progress toward deficit reduction in the coming year.

GETTING FROM HERE TO THERE

But, while we believe that significant movement toward balancing the budget is important this year, we also believe that a budget is more than a balanced sheet. It also reflects decisions about priorities, investments, and values. For that reason, we believe that responsible and effective long-term deficit reduction will require action on both the spending and the revenue side of the budget. We are not likely ot achieve the twin goals of deficit reduction and sustained economic growth unless we review carefully our options on both the spending and the revenue side of the budget.

While we would like to believe that the task of deficit reduction could be accomplished entirely by cuts on the spending side of the budget, this route is simply not possible.

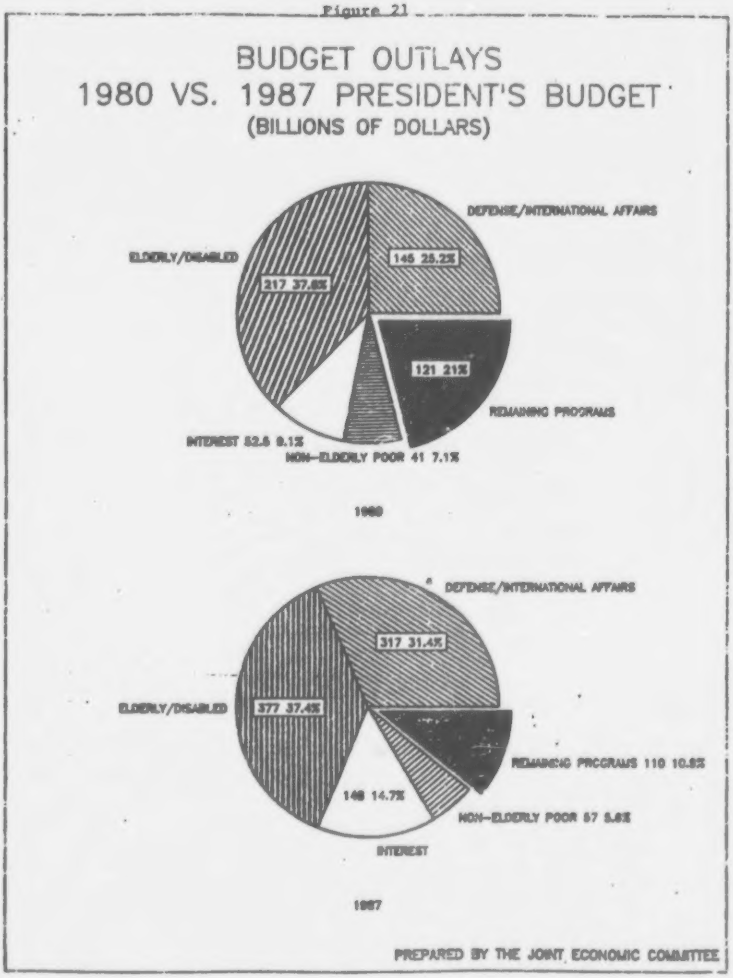
Figure 21 demonstrates that changes in the budget over the last six years have already cut heavily into the nondefense discretionary portion of Federal spending.

Spending for non-elderly poor has increased in nominal dollars but has declined as a percentage of the budget from 7.1 percent to 5.6 percent, and has declined in terms of per capita real dollars because of the increse in poverty we have experienced during the 1980's.

Spending for the elderly has grown in nominal terms but has stayed constant at 37 percent of the total budget.

Spending for two other categories, defense and foreign affairs, and interest on the debt have grown in nominal terms and as a percentage of the total budget. Defense rose from 25.2 percent to 31.4 percent, while interest rose from 9.1 percent to 14.7 percent.

Figure 21


BUDGET OUTLAYS
1980 VS. 1987 PRESIDENT'S BUDGET
(BILLIONS OF DOLLARS)
DEFENSE/INTERNATIONAL AFFAIRS
145 25.2%
ELDERLY/DISABLED
217 37.8%
121 21%
REMAINING PROGRAMS
INTEREST 52.5 9.1%
NON-ELDERLY POOR 41 7.1%
1980
DEFENSE/INTERNATIONAL AFFAIRS
317 31.4%
ELDERLY/DISABLED
377 37.4%
REMAINING PROGRAMS 110 10.9%
148 14.7%
NON-ELDERLY POOR 57 5.6%
INTEREST
1987
PREPARED BY THE JOINT ECONOMIC COMMITTEE

That means that the major part of the budget that is being squezed is the portion that contains two functions:

(1) The day-to-day operation of vital government activities which range from tax collection and drug interdiction to environmental enforcement and law enforcement, and

(2) Investment in activities that increase America's ability to compete for the remainder of this century. That includes everything we invest in the development of our children by way of education; everything we invest to expand our scientific knowledge—whether it is knowledge to keep us on the leading edge of technological change or knowledge to improve our prevention and treatment of cancer and other dreaded diseases. It includes investments in the things that make our communities places where business can make a buck and provide jobs—investments like roads, sewage treatment facilities, etc.

Under the President's recommendations, this remaining portion of the government's budget (operations and investment) will have been cut in half as a percentage of the total budget since 1980. In addition to being slashed as a percentage of the budget, the purchasing power of the dollars in this budget category will have been reduced by more than one-third in real dollar terms.

The Congressional Budget Office has indicated that even without the President's new budget, domestic discretionary programs have been reduced from a high of 5.8 percent as a percent of GNP in 1980 to 4.1 percent today. That puts it below the 4.2 percent level that prevailed in 1962 before any of the Great Society programs were enacted. Under the CBO baseline it will decline to 3.4 percent of GNP by 1991. Under the President's new budget it will shrink to 2.7 percent, a full 34 percent below the level at which we funded these activities before we made the commitments represented by the Great Society. This is clearly unacceptable for society and the economy.

But the most important information these charts provide is that the Administration's professed budget priorities are clearly inconsistent with their espoused fiscal policy goals as well as the legal requirements in Gramm-Rudman.

The President says that he will maintain a social safety net for the truly needy. The President has also said, and most recently Secretary Baker has testified before the House Budget Committee, that social security and entitlement programs must be maintained and the charts indicate that the retirement portion of the budget has been sustained. Interest will continue to grow with the growth in the national debt, and we are all familiar with the President's insistance on significant increases in defense and foreign aid. In terms of new budget authority, he is asking more than 8 percent real growth in defense for the coming year alone.

Most of the cutting has to continue to come from the small portion of the budget that has already been savaged for the last five years. Clearly, even the White House is beginning to feel uncomfortable with what is happening with that portion of the budget. They could have actually reached the $144 billion Gramm-Rudman target without shaving $14 billion from the defense outlay estimate if further cuts in the "remainder" category were less painful to them.

The thrust of Administration budget policy has clearly been to shrink the investment portion of the budget. But the big problem is that, even if the Gramm-Rudman targets are met in Fiscal Year 1987, there is still $144 billion in deficit reduction to go and only $110 billion is left in the only major portion of the budget this Administration has targeted for shrinkage.

In later sections of this Report, we will outline what we believe are important national priorities which, in the context of overall deficit reduction, deserve a higher priority in the budget process. To accomplish needed deficit reduction and reorientation of priorities, we believe it is essential that the *entire* budget be open for negotiation between Congress and the President.

The importance of broadening the base upon which to make deficit reductions is obvious from a breif review of the basic mathematics of the budget.

The potential base from which to begin deficit reductions is significant. Taxes for Fiscal Year 1986 revenues are expected to be about $780 billion, and government spending other than interest, which of course cannot be touched, is $860 billion. Adding the two gives a potential base for budget reduction of $1,640 billion.

But, of that $1,640 billion base, Gramm-Rudman exempts certain entitlements from deficit reduction, cutting the eligible pool by some $275 billion. In addition, the President has sought to exempt revenues, that is $780 billion, and the defense budget, another $275 billion.

Making all these deductions from the $1,640 billion potential cutable base leaves only $310 billion upon which deficit reduction will be concentrated. That is not a broad enough base to do the job. Therefore, we must put the entire budget "on the table" in any responsible effort to accomplish spending reductions.

REVENUES

No one is advocating an increase in individual income tax rates. But there are numerous methods of increasing revenues without raising individual income tax rates including changes in the revenue code which the Administration professes to support that would force individuals and corporations not now paying their fair share of taxes to do so.

The search for deficit reduction is frequently obstructed by the argument that "if the public is asked to choose between increased taxes and spending cuts, they prefer spending cuts." We agree with that assessment. But if the public is given the choice between cutting cancer research, cutting educational opportunity, and cutting assistance for young families to own homes, or making corporations and individuals who currently pay no taxes begin to carry their fair share of the load, we believe they would choose the latter. It is our belief that, given a choice, the American people would prefer to have revenue raised from those sources to be used first for deficit reduction before it is used to finance another round of tax reductions for upper-income individuals.

There are many reasonable options available:

Short-Term: If the tax reform bill passed by the House is enacted in its current form, the Ways and Means Committee estimates that individuals will pay about $140 billion less in taxes during the next five years, while corporations will pay about $140 billion more. In its present form, the bill is "revenue neutral." It should be possible, however, to combine tax reform with increased revenue through improved minimum taxes, more effective base broadening, or other modifications. All of these alternatives should be pursued to achieve the revenues needed for an effective deficit reduction package.

Long-term: From our point of view, suggestions for a simple business transfer tax standing alone are unacceptable because of the highly regressive nature of such a proposal. But such a revenue measure could be designed to be progressive, either through specific exemptions, through an income tax credit, or especially through using a portion of the revenue to permit exempting the first several thousand dollars of income from social security taxes. Such an approach could offer an opportunity to attack simultaneously the Federal budget deficit and the trade deficit (because such a measure could be imposed on imports and rebated on exports). It could also be designed to reduce the regressivity of the social security payroll tax. And we recommend intensive exploration of the use of this combination as a long-run method of restructing the tax code.

No matter which of these options is eventually chosen, we believe that revenues must be "on the table" as part of a serious effort to find a viable compromise on the deficit issue.

DUCKING THE PROBLEM: ASSET SALES AS A DEVICE FOR DEFICIT REDUCTION

Putting the entire budget back "on the table" will involve making difficult political choices, and for that reason many will seek "gimmicks" which appear to accomplish deficit reduction without forcing confrontation with those hard issues.

One possible method of achieving the needed deficit reduction is to sell off the marketable assets of government. The government owns a substantial number of assets both physical (dams, roads, land) and financial (loans to small businesses, farmers, shipbuilders, etc.), which could theoretically be marketed to the private sector. Such asset sales could theoretically be reported on the books of the Federal Government as "revenue," and such revenues would have the effect of reducing the deficit.

Under the heading of "privatization," the Reagan budget calls for precisely this strategy for reducing the deficit. The budget proposes selling the Bonneville Power Administration and three other regional power agencies, the Naval Petroleum Reserves at Elk Hills, National Weather service satellites, and other assets. Such sales are expected to yield about $7 billion in Fiscal year 1987 and $10.5 billion in Fiscal Year 1988.

There may be a legitimate case for disposing of certain assets presently held by government, but any such sales should not damage the public interest and should not be pursued if they are mere bookkeeping transactions that make today's books look better by making tomorrow's books look worse.

From an economic point of view, there are three fundamental reasons why asset sales may be inappropriate as a means to reduce the deficit:

(1) Asset sales justified purely as deficit reduction would be a reversal of the burden-shifting device which deficits represent. While the running up of deficits pushes the payment for present obligations off into the future, the sale of earning assets borrows from a future income stream in order to satisfy current consumption demands; merely making the deficit smaller today by making the deficit larger in the future.

Trying to balance the budget by selling off the government's loan portfolios will cost the Treasury interest revenues from those securities. That will contribute to larger deficits in the future or greater taxes for future taxpayers.

(2) Assets do not correct in any way the *economic* problem of Federal borrowing crowding out private investment. Asking private wealth holders to purchase government assets directly instead of indirectly through the purchase of government debt securities merely reshuffles the form of ownership of the assets, it does nothing to reduce the economic problems caused by deficit finance. Transferring public wealth to private hands will do nothing to increase private funds available for investment.

(3) Indiscriminate sale of government assets can be bad accounting, for it fails to acknowledge the distinction made earlier between capital and current expenses of government. Asset sales affect the disposition of capital, and, if the government kept its accounts like any private business with separate categories of current and capital expenditures, disposing of government assets would not affect profits and losses.

BEYOND FISCAL YEAR 1987: LONG-TERM CONCERNS FOR FISCAL POLICY

Up to this point, we have examined the short-term problems of deficit reduction and the mechanisms needed to accomplish deficit reduction this year. But, beyond the near term, we believe it is important to establish some targets for fiscal policy.

It is important to remember the reason we are trying to go through this deficit reduction exercise. We are doing it because we believe these deficits have become so huge they harm the ability of the economy to achieve its full potential for noninflationary economic growth. We are doing it not because we like neat balance sheets, but because deficits of this magnitude have kept interest rates too high, leading to farm foreclosures and an inability of young families to afford mortgages. Excessive deficits create an overvalued dollar, bankrupting trade-sensitive industries, and throwing thousands of American workers out of their jobs and choke economic growth. They rob our children of their prosperity by borrowing from the future to support today's consumption rather than investing in the future to expand economic opportunity. What matters about deficits, therefore, are real things like rising unemployment, high interest rates, and reductions in future prosperity.

Because of these realities, we believe that Federal fiscal policy should seek to reduce the *real* budget deficit to zero, but to achieve

that target, it is essential that we agree on the correct method of accounting for deficits.

Frankly, at the moment, we do not have an agreement among the Members of this Committee about the correct method of measuring Federal deficits. But we believe that this is an important subject which should be the focus of substantial debate and discussion in the coming year. We do not need to resolve this debate this year, for we believe this year's deficit reduction target of $144 billion is realistic. But as the deficit reduction process moves forward and we reduce the nominal deficit toward zero, the issue of what the "real" deficit is will become more acute, particularly if the economy starts to falter.

In the following paragraphs, we will discuss a few of the important issues which arose at our 40th Anniversary Symposium concerning the proper measurement of Federal deficits and the proper targets toward which fiscal policy should aim. In recounting this discussion, it is worth emphasizing that there was a substantial consensus among the economists that reducing the nominal deficit to zero may not be the most appropriate method for getting the real deficit to zero.

In order to calculate the "real" deficit, economists have argued that we need to factor into our calculations two important variables: the level of unemployment and the effects of inflation.

Unemployment

If there is substantial unemployment and idle capacity—if we are short of full employment and there is insufficient private demand to keep factories and workers fully employed—then many economists argue that government ought to help create sufficient demand through tax reductions or increases in spending. This sort of "fiscal stimulus" helped pull America out of the Great Depression, and has since helped the enomomy recover from recessions.

To measure whether government fiscal policy is stimulative or depressive on the economy, economists have long calculated a "full employment" deficit—the deficit in the Federal budget which would exist if the economy were operating at full employment. Alternatively, a distinction is frequently made between the "cyclical" component of the deficit, which is produced by the performance of the economy, and the "structural" deficit, which would persist even if the economy were operating at full capacity. Republican Administrations routinely testified, in the late 1960's and early 1970's, that balance in the structural deficit was the correct goal of fiscal policy.

In the view of many economists, the coorect deficit reduction strategy to achieve maximum economic growth without inflation would be to target that full employment or structural deficit. In their view, the best way to manage noninflationary economic growth is to aim for a reduction of the structural deficit to zero, but recognizing natural variation in the cyclical deficit in response to changing conditions in the economy. To do otherwise would be to accept high unemployment as a tolerable condition, beyond the reach of fiscal policy.

Inflation

As with most other financial matters, inflation plays havoc with traditional accounting with respect to deficits. A homeowner who buys a $50,000 house with a $40,000 mortgage would carry a heavy debt burden. But if inflation raises the value of that same house to $100,000 over 10 years and raises the owner's income over that same period, that $40,000 mortgage shrinks significantly in terms of its real burden on that homeowner. The same is true with the Federal deficit.

If we are concerned about the effect of the deficit on the economy, then many economists argue that we need to account properly for the tricks which inflation plays on deficit accounting. According to calculations made by Professor Robert Eisner of Northwestern University, the failure to make such corrections can lead to dangerous overestimates of the amount of fiscal stimulus being applied to the economy by nominal deficits and can result in an unnecessary restriction on eonomic growth.

If that argument is correct, failure to accurately measure the deficit in real as opposed to nominal terms could produce a significant shortfall in total demand in the economy and prevent the economy from achieving its maximum noninflationary growth potential.

If these economists are correct, an appropriate long-term goal for Federal fiscal policy would be to balance the inflation-corrected budget at full employment. Ignoring these factors, and seeking to balance the nominal deficit no matter what the level of unemployment, could seriously damage both the contemporary economy and the rate of future growth.

As indicated above, the committee is not agreed on this point, but it will be holding further hearings on this subject in the coming year.

V. Moving Toward Strong Growth and Full Employment

The stated goals of the Employment Act were that government should use "all practicable means" to achieve "maximum employment, output, and purchasing power." In 1978, the Humphrey-Hawkins Act clarified the intention of the Act by adding the words "full employment" and "balanced growth" to the list of policy objectives.

We believe that the country should give substantially more attention to the goals of economic growth and that we should resurrect for public discussion a consideration of the goal of "full employment." We are disturbed by what appears to be growing official complacency about slow growth and high unemployment in the American economy. Last year's 2.3 percent increase in real GNP is not nearly good enough, nor is today's unemployment level of 6.7 percent—an official statistic which, in our opinion, fails to measure the true level of idle human capacity in the American economy.

We believe there is substantial room in the economy for lowering the unemployment rate significantly without raising the rate of inflation, and we believe that this should be an important goal for economic policy. We believe there are three basic policy directions which must be followed if we are to achieve the goals of rapid growth and falling unemployment: a growth-oriented monetary policy; human capital investment strategies aimed at the displaced and the structurally unemployed; and productivity-enhancing reforms of the industrial relations systems.

A GROWTH-ORIENTED MONETARY POLICY

Because of the constraints imposed on fiscal policy by the necessity of reducing the budget deficit, we believe that primary responsibility for promoting growth and reducing unemployment will, by default, fall to the Federal Reserve Board. Without built-in and discretionary fiscal stabilizers, the monetary authorities will have to act more boldly to preserve stability and growth in the American macroeconomy.

The history of American monetary policy is one of persistent conflict with fiscal policy, a preoccupation with inflation, and, recently, a cautious flirtation with a monetarist preoccupation with money supply aggregates. We believe that conditions have changed sufficiently in other aspects of the American and world economies that the stage is set for a significant, positive departure of monetary policy from this tradition.

During the 1950's, monetary policy played a background role in American economic policy. It provided liquidity for an expanding economy, and kept nominal interest rates within acceptable limits. But, as inflation began heating up in the 1960's, monetary policy was increasingly called upon to deal with price increases through shutting down growth in the economy. As Professor James Tobin notes:

> . . . We've had six recessions beginning in 1957, all of which could be interpreted as being deliberately contrived recessions in order to reduce inflation.—JAMES TOBIN.

In the era of "stop-go" economics, it was monetary policy which was called upon to play the role of brake, while fiscal policy generally pressed on the accelerator.

As inflation accelerated in the 1970's, more and more attention came to be paid to the ability of monetary policy to deal with inflation. Policymakers took increasing interest in the theory of monetarism, which suggested that inflation was entirely a monetary phenomenon which could be controlled by adopting a slow and predictable path of growth in basic monetary aggregates. In theory, such a steady rate of growth would reduce the rate of inflation without precipitating a recession.

In pursuit of this theory, after 1979, the Fed imposed upon itself targets for the growth of intermediate monetary aggregates—M1 and M2. Once it had set these targets, the Fed was reluctant to deviate from them even when adherence to them caused severe problems for the economy.

There can be no doubt that adherence to this policy regime caused severe problems. Contrary to the theoretical claims of monetarism, the tight-money policy precipitated an economic downturn unparalleled since the Great Depression, driving real interest rates to extradordinary highs and creating massive unemployment and widespread bankruptcies.

This dilemma became acute and dangerous in 1982, when the Mexican debt crisis and an unanticipated and persistent decline in the velocity of money meant that sticking to the targets implied a further severe decline in nominal and real GNP. Eventually, the Federal Reserve made what we believe was a correct decision and chose the economy over M1 as the principal focus of monetary policy.

This year's Economic Report of the President provides a table which clearly documents both the abandonment of monetary targeting as a strategy for the Federal Reserve and the clear failure of reality to bear out the theories of the monetarists. (Chart 1.1, p. 28.) In spite of a rapid increase in the rate of growth of the money supply, inflation has not rebounded, but the economy has. We believe that such evidence confirms the wisdom of the Federal Reserve's policy of *de facto* abandonment of monetarism. But we believe that other factors warrant a more explicit renunciation of targeting of monetary aggregates.

We believe that fundamental changes in the U.S. and world financial markets make it both technically difficult and economically imprudent to establish and stick to strict targets for growth in monetary aggregates at this point in time. Two factors in particular seem especially relevant: it has become very difficult to anticipate or measure the velocity of money, and the internationalization of capital markets makes it much more difficult for monetary authorities to control the basic money supply.

Velocity.—Last February, the Federal Reserve announced that its monetary targets for the four quarters of 1985 were 4 to 7 percent for M1, 6 to 9 percent for M2, and 6 to 9.5 percent for M3. These were believed to be consistent with growth and nominal GNP of 7.5 to 8 percent over the same period. Growth in M2 and M3 was within the targets, but M1 grew by 11.6 percent, well above the upper limit of the range. Nominal GNP rose over the period by 5.8 percent, less than the Fed projected; this indicates a breakdown in the implicit estimate of velocity, the ratio of nominal GNP to M1.

Internationalization.—The globalization of financial markets makes it very difficult for the United States to control its money supply, one of the most important traditional macroeconomic policy instruments. In 1984, for example, the basic money supply in the United States (currency and highly liquid deposits in financial institutions) was between $500 and $600 billion, but the Eurodollar float was over $1 trillion and global short-term capital flows total $2 trillion.

In light of these two factors, we think it is time for Congress to explicitly encourage the Federal Reserve to move away from targeting monetary aggregates and begin targeting real variables, such as GNP, employment, interest rates, and exchange rates.

Twice a year, the Federal Reserve reports to congressional committees its monetary targets for the coming quarters and its "projections" for GNP, prices, exchange rates, and unemployment. Since the Fed has been shifting emphasis to macroeconomic performance and downgrading money stock growth, we believe these "projections" should be treated as the actual targets toward which monetary policy should aim.

Switching of monetary policy from targeting monetary aggregates toward targeting real economic performance may result in a period of somewhat more rapid growth in the money supply. Traditionally, such growth ignites fears of inflation, but we believe there are three basic reasons why the current environment makes inflation much less of a problem for a growth-oriented monetary policy.

The first factor is that inflation seems to be well under control, and that there are not obvious upward price shocks anywhere on the horizon. Producer prices are actually declining, as are commodity prices and oil prices.

This resembles the situation back in the 1950's and 1960's when food and import prices were rising more slowly than the CPI and exerting a downward drag on the inflation rate. This permitted us to reduce unemployment to around 4 percent without causing any undue inflation. In retrospect, it is clear that, without these favorable price trends, we could not have reduced the unemployment rate below about 5 percent without generating inflation. Present price trends seem to suggest that the 1980's could also be a period of lower unemployment and low inflation.

Trends in the labor market also lead to the same conclusion. High unemployment of the past few years has seriously eroded the ability of labor to win wage increases, and last year's wage increases were actually below the rate of inflation. While such developments are not healthy for family incomes, they do suggest that labor markets are unlikely to drive inflation upward if monetary policy turns expansionary. In the words of Conference Board economist Audrey Freeman:

> The exact tradeoff between inflation and unemployment should be much less of a deterrent in the 1980's than it was at least rhetorically in the '70's to policies designed to promote fuller employment of our human resources. We have a much more flexible and fluid employment market and wage-setting practice than we thought.—AUDREY FREEDMAN.

Trends in both commodity markets and labor markets, therefore, suggest that the "inflation-safe" rate of unemployment is well below the current unemployment rate and may even be as low as the 4 percent which was the target envisioned by the Humphrey-Hawkins Act.

Finally, Federal fiscal policy should also help ease the inflationary pressures on monetary policy. Federal fiscal policy will undoubtedly move in a less expansionary direction in the years ahead, no matter what the courts decide on the constitutionally of Gramm-Rudman. In such an environment, it is important that the Federal Reserve use monetary policy to make up for the loss of aggregate demand.

> However, if the Federal Reserve targets GNP, either nominal or real, then the lost aggregate demand will be replaced by the Federal Reserve through easier money and lower interest rates and, therefore, there need not be any effect on aggregate demand.—ALAN BLINDER.

In such a climate, we believe it would in fact be dangerous to the health of the economy to tighten monetary policy at the same time fiscal policy was moving in a contractionary direction.

> If they tighten now on top of these budget cuts, we will have a significant slowdown in the economy, if not a recession by 1987.—**Lawrence Chimerine.**

Taken together, we believe that these factors create a substantial amount of room for monetary ease in the coming months. This could well prove fortuitous, for the problems in the financial sector noted earlier in this Report could well demand a significant increase in the domestic money supply in any case, if the Federal Reserve is forced into more rescue operations, such as the recent one at Continental Illinois.

The principal constraint on such a policy appears to be concern about the exchange value of the dollar. The strongest argument against monetary ease appears to be that it could precipitate a dollar crisis as foreigners suddenly withdrew their funds from American capital markets.

Evidence suggests that these concerns are genuine, and urge the Federal Reserve to include the exchange value of the dollar as one of the real targets toward which to orient monetary policy. But it would be inappropriate for monetary policy to be dominated entirely by a concern for the dollar. In a later section of this Report, we will make recommendations concerning international monetary relations and the coordination of macroeconomic policies among major trading nations. Such policies will help produce an orderly repricing of the dollar to more reasonable levels, and should help increase the freedom of action for the Federal Reserve to orient domestic monetary policy toward a rapid expansion of the domestic economy.

HUMAN CAPITAL INVESTMENT

Even with the favorable inflation forecast mentioned earlier, one major obstacle to a macroeconomic strategy of sustained, rapid growth is the ability of the work force to function effectively in a high-growth, high-employment economy. If workers do not have the skills needed by firms, then an increase in aggregate economic activity will quickly translate into wage inflation as firms bid up the wages of the limited pool of qualified workers.

We believe it is a bad solution to this dilemma to run the economy with such high levels of unemployment that there is a large pool of qualified workers always out of work. Instead, we believe that public policy should work toward improving the skills of all our workers so that the needed skills will be available even with very low levels of overall unemployment. We believe it is a proper and cost-effective role for government to invest in "human capital"—the worker skills which will make it possible for us to run an economy with both high employment and low inflation.

An effective "human capital" investment strategy requires a focus primarily on two groups: the "structurally unemployed," who lack the skills needed for productive work; and the "displaced workers" whose skills have been rendered obsolete by competition or technological changes.

The structurally unemployed

Employment and training programs targeted to those with inadequate skills have been received a high priority. Even at their peak funding levels in the late 1970's, total outlays never exceeded $12 billion or 2 percent of all Federal outlays, with the programs serving about 4 million people or 4 percent of the labor force—many for very short periods of time. Funding for these programs stood at $9 billion in 1980, but has since been cut sharply to today's total of less than $4 billion.

But these budgets cuts do not necessarily reflect informed judgment on the actual success or failure of past programs. Studies of many programs funded under the Comprehensive Employment and Training Act showed strong earnings gains for participants, especially those with the lowest levels of basic skills. And the Job Corps, an intensive program of remedial education, skill training, health care, and other supportive services for very disadvantaged youth, is frequently cited for its positive benefit-cost ratio.

We believe that continued funding of employment and training programs targeted at the disadvantaged, if properly designed and coordinated with macroeconomic policy, can reduce the natural rate of unemployment and permit more overall stimulus to be applied. We believe that fiscal stimulus targeted on particular groups of workers or sectors of the economy with high rates of unemployment is less inflationary than across-the-board stimulus because such expenditures help improve the productivity of workers and, thus, enhance the ability of the economy to generate higher employment without inflation. Further, we believe the evidence is strong that private market forces alone will not remedy the skill deficit of the structurally unemployed. In this, we agree with Princeton's Dr. Bernard Anderson when he states:

> . . . as we look toward the future in trying to improve productivity, trying to control inflation, and trying to achieve greater competitiveness in international markets, we should remember that the nation, in my judgment, has a commitment to full participation in all segments of our population in our economy and that, in order to fulfill that commitment, it will be necessary to support labor-market policies aimed at structural unemployment. We cannot assume that the market alone will solve the problem of structural unemployment. It never has and it never will.—BERNARD ANDERSON.

Displaced workers

In the past few years, millions of American workers have lost their jobs because of structural changes in the U.S. and world economies. From 1979 to 1984, 11.5 million American workers lost jobs because of plant shutdowns or relocations, rising productivity, or shrinking output. According to the Department of Labor, displaced workers accounted for about 14 percent of unemployment in January 1984.

The economic recovery neither stopped nor even greatly reduced displacement. Displacement is an ongoing process, associated with technical and economic change. According to BLS, over 1.2 million workers were displaced even in 1979, by most standards healthy year economically. And, more recently, in Santa Clara County (California's Silicon Valley), semiconductor industry employment fell by about 2,000 in a few months, from 51,000 in November 1984 to 49,000 in May 1985. In the semiconductor industry as a whole, employment fell by 9,600 between its peak in December 1984 and July 1985.

Some of these workers—especially younger workers with skills in demand or the right educational background—have little trouble finding new jobs. Others—hundreds of thousands a year—remain out of work for many weeks or months, even for years. Many of the displaced are middle-aged, unskilled or semiskilled, manufacturing workers with long and stable job histories. Given the pace of technological and structural economic change, they may be left behind.

The Federal Government needs to be far more active than it has been in developing effective training and retraining programs for displaced workers. The major effort to date has been Title III of the Job Training Partnership Act (JTPA). A recently released study by the Office of Technology Assessment shows that JTPA programs are helping displaced workers find new jobs. However, the report showed that *no more than 5 percent of eligible displaced workers are being served.* To help provide the skilled work force that American industries need to maintain competitiveness in the world economy, the program will have to reach many more displaced workers, and emphasize training—particularly basic skills training—more strongly.

We believe that a greater commitment to training for displaced workers is justified because these people bear a disproportionate share of the burden for having a dynamic, adaptable, and generally open economy. Displaced worker programs may be viewed as essential to an open trade policy and for a labor market that permits private employers considerable latitude in hiring and firing—much more than in some other industrialized countries. The price of an inadequate program for retraining displaced workers is rising pressure for protectionism.

In reviewing the present state of programs for displaced workers, we note the conclusion of the Office of Technology Assessment: Whether Title III is an effective and sufficient response to the problem of worker displacement is questionable.

Providing effective retraining for displaced workers will require a Federal effort which is more than "questionable."

INCREASING PRODUCTIVITY

We believe that a growth-oriented monetary policy, a deficit-reducing fiscal policy, and an effective human capital investment strategy will contribute significantly to the overall growth of the economy. But these innovations will fail to yield the desired results if workers and firms do not react to the new environment with new patterns of behavior. Stimulative macroeconomic policies will not translate into significant wage growth without inflation unless the microeconomic structure of our economy responds to such stimulus with structural reforms aimed at enhanced productivity.

Restoring productivity growth is essential for reversing the pattern of real income stagnation noted in an earlier section of this Report. This is especially true in light of the increasing challenge of international competition. In the past, as Alan Blinder notes:

> The wage gap between the United States and a lot of the rest of the world was far larger in the 1950's and 1960's than it is now and we had no difficulty competing abroad on the basis mainly of better productivity.—**Alan Blinder.**

Since we want to remain as a high-wage country, U.S. enterprises cannot win a wage-cutting competition with the third world or even Japan and the newly industrializing Pacific rim countries. Our companies must, therefore, rely heavily on technology, management systems, and labor skills to compete in world markets as a *high-wage, high-productivity* economy.

And the evidence is mounting that a resumption of productivity growth depends fundamentally on a reorientation of our traditional assumptions about the relationships between workers and managers in American enterprises.

Productivity has been a central concern of economic policy for more than a decade, since our rate of growth in productivity slowed while our competitors continued to press forward with significantly greater productivity gains.

Until recently, the major thrust of public policy for enhancing productivity has been incentives to capital investment. The justification was that rising capital per worker would be sufficient to resume a high rate of productivity growth. This theory supported the recent shift in tax policy toward more liberal treatment of investment; a shift which appears to have neither increased investment as much as hoped nor reversed the historical patterns of stagnant productivity.

Recent performance of both capital investment and productivity do not demonstrate conclusively that further capital subsidies represent an assured solution to our productivity problem.

> The rationale for stimulating capital formation as a way of restoring productivity growth remains shaky, though. There is little evidence that the productivity slowdown is due to a slowdown in the rate of capital formation.—**William Branson.**
>
> Most of the public discussion has focused upon slower capital formation as the major casual factor. I conclude that the importance of that factor has been greatly overstated and does not match the specific facts available.—**Barry Bosworth.**
>
> Perhaps the most often cited explanation behind the productivity slowdown is that the rate of capital formation has not been rapid enough to deepen the capital stock, causing a decline in the ratio of capital to labor. However, while we believe that this explanation has some merit, its impact is generally overstated.—**Lawrence Chimerine.**

> There appears to be no unambiguous relationship between changes in gross or net investment and changes in productivity growth—the period 1956-1960, for example, was one of relatively low ratios of net investment to GNP and yet relatively high productivity growth. . . . recent BLS studies have not established strong relationships between capital-labor ratios and productivity.—RAY MARSHALL.

It seems clear to us that, while capital incentives provide a useful support for productivity, recent statistics do not demonstrate that they are the only, or perhaps even the most essential, ingredient for raising productivity growth.

Broad statistical studies on productivity growth provide a clear indication that historically a very large part of all improvements in productivity come from improvements in the quality of human resources; physical capital generally has been found to account for no more than 20 percent of productivity growth.

This should not be surprising, because educated and trained people are better able to deal with change and solve problems. A better-educated work force is also better able to adopt new technologies and create new innovations.

But, in addition to improvements in the educational endowments of workers, the evidence is also mounting that the quality of relationships *among* people is equally important to productivity growth. Although econometric studies of the reasons for the slowdown in productivity growth have produced inconclusive and conflicting results, there is evidence that productivity can be improved by better management and industrial relations systems. There is some evidence, moreover, that deteriorating labor-management relations during the 1960's was associated with declining productivity growth.

INDUSTRIAL RELATIONS IN A DYNAMIC ECONOMY

The current labor market and industrial relations system evolved as a requirement of a modern economy built on the principles of specialization and large-scale production. Under the banner of scientific management (Taylorism) in vogue around the turn of the century, these principles were pushed to their limits. They served greatly to increase productivity and standards of living at a time when most of the labor force was both poor and poorly educated by today's standards, and the cost-reducing benefits of large-scale industrial technology were enormous. But this system also treated workers like cogs in a machine, and led to a kind of rigidity in the American firm which made it difficult for both managers and workers to respond to technological change.

This history has bequeathed us an industrial relations system that is far less democratic than the polity it inhabits, and one that pits management against labor in a strongly adversarial process. While this may have served us well in the past, it is not the kind of system needed to meet the challenge of a technological complex and increasingly competitive world.

Adversarial relations make it difficult for labor and management to establish the kind of cooperation and mutual trust required for quality output, productivity, and flexibility in adjusting to change. In the internationalized information world where workers have higher levels of education, authoritarian, adversarial management systems deprive enterprises of the productivity and creativity of workers who know their jobs better than anyone else in the organization.

Modern industrial relations must recognize that workers have changed—they are no longer content to be treated as cogs in a machine, and are looking for more satisfaction from work than a check at the end of the week. Modern industrial relations must also recognize that markets for products are changing quickly, and that effective competition requires the ability to retool and reorient production on very short notice.

In such an environment, labor relations practices which ensure worker security mainly through contract, job control, and detailed regulations may well inhibit productivity. We may be in need of a "new deal" in industrial relations; one which gives greater attention to quality, productivity, flexibility, and international competition.

This "new deal" could involve two basic elements: first, greater worker involvement in, and identification with, the firm. Second, a greater reliance on "gain sharing" as a form of compensation.

Increasing worker identification

Enhanced worker involvement may be promoted through the increased use of mechanisms such as quality circles and team-based production. But, more importantly, it means that *firms* must evidence a greater commitment to the well-being of their workers, primarily through a greater degree of employment security.

Under the old industrial relations system, workers sought to ensure their employment security by negotiating rules which set limits on the ability of managers to assign jobs. This practice sought to purchase *employment* security for workers by limiting *job* flexibility by managers. Such a system did guarantee employment security for workers in stable industries, but industries subject to fluctuations in demand were forced to deal with those fluctuations by using layoffs to regulate the output of the firm. As our economy has become more dynamic, more and more firms are confronting unstable and changing situations. Rigid job definitions limit internal flexibility and force more and more firms to resort to layoffs. This reality means that the old industrial relations system produced neither employment security nor job flexibility.

There appears to be growing recognition by American employers that layoffs are an inefficient way to control costs: layoffs themselves are costly because of severance pay, unemployment compensation, and other costs; layoffs also could cause the best employees to take other jobs; and job insecurity leads to efforts to establish inappropriate rigidities, including defined seniority lines and rigid job descriptions with prohibitions on work outside a job classification.

In the words of one executive, dealing with business cycle fluctuations through layoffs means:

> We're essentially soiling the nest, we're making it impossible for these people to truly commit themselves to what they're doing.—SHELDON WEINIG.

The "new deal" seems to suggest that employers provide *employment* security, in return for workers accepting job flexibility.

A popular 1982 book by Robert Waterman and Thomas Peters (*In Search of Excellence*) found that many of America's best-run companies have job security or "no layoff" policies.

The Japanese industrial relations system has long emphasized stability of employment, and this stability may have contributed to the recent Japanese "victory" in developing the 64K RAM chip.

Because of high turnover in the United States:

> The training and retraining of workers put a strain on Silicon Valley companies that the Japanese, with their traditional job stability, avoided. Because of the worker's greater continuity—and possibly their greater dedication—the Japanese companies offered higher quality chips. The quality of U.S. chips has improved greatly in recent years but is still lagging behind the Japanese.—(Fortune, Dec. 14, 1981, p. 56)

This trend toward increasing employment security is evident in Europe as well. According to MIT's Michael Piore:

> In most other industrial countries, managers have much greater freedom to assign work to individual employees as they deem necessary and to vary those work assignments to fit the requirements of the production process. But they do not have this freedom because they are unrestrained. Rather, the freedom exists because the nature of the restraints is different. In general, managers abroad are not free to lay off workers in response to changing market conditions, and they must guarantee the worker a fixed wage rate whatever his current job assignment.—MICHAEL J. PIORE.

An additional positive feature of employment security is that it makes it more difficult for managers to shift responsibility for their failures onto workers through layoffs. A company committed to providing work for its employees is likely to be forced to make creative use of its human resources and thereby improve the quality of management.

For all of these reasons, we think it essential that American business follow the recommendation of the President's Commission on Industrial Competitiveness and: Consider new human resource research strategies that will create a climate more conducive to improving productivity, product quality, and the quality of working life especially with respect to employment security in the American work force.

Contributing to fuller employment without inflation

The second key to the "new deal" in labor relations involves eliminating the inflationary bias which was built into the old system. Traditional, decentralized wage bargaining systems were conducive to whipsaving (raising wages by playing one employer off against another) and leap-frogging (union leaders escalating wages in competition with each other); long-term contracts with cost-of-living adjustments and annual improvement factors tended to cause temporary factors to increase the wage base and therefore ratchet the compensation base upward.

It was these features of our industrial relations system which helped to transform external price shocks (particularly oil and food) into a sustained general rise in the price level of the economy throughout the 1970's. The deep recession of the 1980's has forced many firms and workers to suspend the old mechanisms of wage-setting, but no new set of wage-setting rules have been put in their place.

Without such new mechanisms, we are concerned that if the growth-oriented macroeconomic policies outlined earlier were put into place, the resulting drop in unemployment could cause the old mechanisms to kick back in again, limiting the ability of the economy to drive unemployment down further while maintaining low inflation.

It seems clear that both workers and firms might benefit from a new mechanism of wage-setting, one which recognizes that the well-being of employees must be tied to the well-being of the companies for which they work. Some form of "gain sharing" appears to offer good potential for establishing such a link.

"Gain sharing" can take many forms, from employees ownership, to Employee Stock Option Plans (ESOP's), to year-end bonuses, to productivity-linked wage contracts. The record of success in gain sharing is impressive, both here and abroad. The recent worker-buyout of Weirton Steel produced impressive productivity gains and made it possible for the company to turn a significant profit last year. In Japan, industrial workers receive semiannual bonuses that average own-quarter of their total pay and can go as high as one-half of total pay. This gives employees a direct interest in the profitability of the firm and helps account for the rapid productivity increases in Japanese industry.

In the United States, only 15 percent of all firms use some form of incentive pay which typically accounts for 5 to 10 percent of total compensation. Moreover, many of these plans are retirement-oriented, deferred profit-sharing schemes rather than immediate cash distribution plans.

We believe that American industry has so far taken too little interest in the establishment of various forms of gain sharing, and we endorse the recent recommendation of the President's Commission on Industrial Competitiveness that we should: Encourage American management to use gain-sharing and profit-sharing compensation plans and equity ownership programs to enhance the worker's stakes in the welfare of the company.

PUBLIC POLICY AND PRIVATE INITIATIVE

We believe that the preceding analysis places the burden of improving productivity on private management. W.S. Deming, the productivity expert who helped create the Japanese system of industrial relations, was always clear that productivity was 85 percent the responsibility of management. And our own executives seem to agree. A 1982 survey of 236 top-level executives in the United States concluded that "management ineffectiveness is by far the single greatest cause of declining productivity in the United States."

> We were beginning to believe we would never lose. We did not develop new management techniques and got off on this ridiculous kick of trying to increase earnings each quarter.—**Malcolm Baldrige.**

This is truly an area to test the Administration's philosophy that private initiative is a better route to progress than public policy.

But we believe public institutions should monitor the productivity and labor relations policies of private firms closely to determine whether they are in fact delivering the kinds of changes which we all believe are essential for restoring growth in American productivity.

In this context, we welcome the efforts of the Department of Labor to take a fresh look at labor law:

> For the last 50 years, the law has assumed that labor and management are adversarial opponents and must have an arms-length relationship. If we're going to be competitive in the global economy, we must have to blur distinctions between labor and management.—**Steven I. Schlossberg**, Deputy Under Secretary of Labor.

But we think it important to underscore the point that "blurring" the distinction between management and labor should be accomplished largely by an increase in worker participation in, and ownership of, the enterprise, not by efforts to weaken the protections afforded by law for the efforts of workers to organize.

In this regard, it could well be time for more creative public policies to promote employment security, job flexibility, and gain-sharing mechanisms of compensation. Over the coming year, the Committee will be exploring a number of legislative options in this area. Some of the suggestions to date which appear to have merit include:

Reforming the unemployment compensation system rules to foster the use of "work-sharing" as an alternative to layoffs. A program along these lines has been in place in California for a number of years, with promising results.

Eliminating or reducing the tax rate on end-of-year bonus payments to employees; perhaps treating such bonuses as "capital gains" for workers.

Assuring firms which receive benefits from the government in the form of trade relief or tax incentives provides an opportunity for their employees to share in investment decisions and in profits.

Encouraging firms to reduce the "spread" between the highest and losest paid employees. Management consultant Peter Drucker has proposed that the maximum compensation of all executives should be limited to some multiple of the compensation of the lowest-paid regular employee. Such changes could be encouraged by shifting the basis of payroll taxes to increase the tax bill on "high spread" companies and reducing it for "low spread" ones.

Finally, we would like to point out that American firms both cannot and should not attempt to avoid the difficult process of internal restructuring by a simple resort of cost-cutting strategies which rely on merely reducing labor costs. Although high unemployment makes it tempting to return to the labor-management climate of the 1930's, we do not believe that such a change is in the long-run interests of either social progress or economic prosperity. In this we agree with Professor Piore that:

> Simple cost cutting is only a short-run strategy which, however appropriate it may be for a particular company at a moment of time, will never serve the interests of a national economic system.—MICHAEL PIORE.

VI. EXPANDING ECONOMIC OPPORTUNITY

Throughout this Report, we have been focusing on the importance of economic growth as a goal for economic policy. We believe growth is important not because we like to see lines moving steeply upward on a graph, but because rapid growth is essential to a broadening of opportunity.

In a booming economy, people achieve upward mobility; in a sluggish one, they move down. Discrimination breaks down faster when companies are scrambling for workers, not when workers are queuing up for jobs. It is no accident that World War II turned "equality of opportunity" from a slogan into a reality. Strong growth is the only solution to the problems of stagnating family incomes noted earlier, and it is the only way to create the conditions under which younger Americans will have a viable chance at achieving the American dream.

While we believe that the best way of expanding economic opportunity is increasing the overall rate of growth in the economy, we believe that other government policies can also play a role in improving the distribution of opportunity. New efforts are needed in the areas of housing, education, and income maintenance to ensure that the American economy is able to deliver on its promise of opportunity for all who are willing to work for it.

Throughout our history, many of the most successful and popular of our social programs were opportunity programs: the GI bill, the VA and FHA mortgage programs, the Morrill Act and the land-grant college system, the Homestead Act, and the Civilian Conservation Corps. Each of these programs was willing to give struggling citizens—especially the young—a chance to better themselves through their own hard work and achievement.

But in recent years, avenues of opportunity have narrowed. As government activity on all levels is cut back, we have allowed social policy to drift away from opportunity.

Consider the perspective of a head of household born in 1921 versus one born in 1961. Now about to retire, the person born in 1921 may have had a father or an uncle who worked on a public works project during the Depression. As a young man, he may have taken his first job with the Civilian Conservation Corps. Returning from World War II, he may have used the GI bill to go to school or gain a skill, and later used a VA or FHA loan to buy a first house. As he raised his family, government helped him and the economy with aid to public schools, an interstate highway system, and the National Defense Education Act. He and his wife now are preparing to retire, using inflation-indexed social security and medicare as their base.

In contrast, the younger man or woman born into far greater affluence in 1961 sees far more restricted opportunities. Throughout their maturing years, in the 1970's and 1980's, they have seen real family income decline. The combined burden of payroll and personal income taxes has increased while the corporate share of taxes has declined. He and his wife are probably still paying off college loans. Social security and medicare taxes become an increasing share of their tax burden, yet they have their doubts whether these programs will survive until their retirement. In addition, housing costs have skyrocketed, absorbing a far larger percent of the family budget. While more safety-net programs exist to protect them should they qualify in a time of serious need, in general, they do not perceive government as an extended hand helping them meet their life's challenges. And should they fall into the safety-net, programs are not well designed to help them get out.

We believe that it is time to return to our historic concern with equity. For previous generations of young Americans, opportunities for home ownership were provided by FHA and VA mortgages, and opportunities for career advancement were provided by the GI bill and the National Defense Education Act. We believe it is time for a renewed public commitment to opportunity programs in the areas of housing and education.

HOUSING

Traditionally, housing has been the principal route of economic opportunity and asset accumulation for most Americans. Owning a house is the single best way for the average family to accumulate any assets at all, and homeownership has been the most effective bulwark against the devastating impact of inflation. Recognizing this reality, it has long been the policy of government to facilitate homeownership, principally through the mortgage interest deduction in the tax code, and the government-sponsored agencies which, in effect, created the 30-year mortgage.

But the ability of these programs to expand homeownership opportunity has been reduced dramatically in recent years. Skyrocketing housing prices and rising interest rates have pushed the costs of housing finance out of reach for millions of young families. The financial advantages of the mortgage interest deduction rise with income, tilting this system toward older and wealthier families, and away from younger, less affluent ones. And although organizations like FNMA and GNMA help organize an efficient market for home mortgages, many young families lack the income to qualify for any mortgage at all.

As a result of these trends, our housing policies are failing to promote homeownership as effectively as they once did, especially for the first-time homebuyer. We believe it is time to reverse this trend, and strongly recommend that the government explore ways to expand ownership opportunities for first-time homebuyers.

At present, states provide the principal form of assistance to first-time homebuyers through tax-exempt bond financing of low-interest mortgages. However, such programs often provide much of the benefit to wealthy bond holders instead of homebuyers and, if these programs are curtailed, it is important that the Administration and Congress develop just and effective alternatives which would significantly expand opportunities for first-time homebuyers.

EDUCATION

Historically, education has been the principal route for upward mobility in American society. For that reason, education programs have been a cornerstone of opportunity policy in this country. Free and universal primary and secondary school education was followed by the creation of the land-grant college system, the GI bill, the National Defense Education Act, and the creation of Pell Grants for higher education funding.

But, in the past five years, the changed budget priorities of the current Administration have dramatically cut Federal support for higher education. In current dollar terms, student aid continued to rise during the late seventies, then began to decline. In constant dollars, student aid dropped after 1976, rising only slightly until 1979, when the Middle-Income Student Assistance Act went into effect. Although the level of funding in 1984 was about equal to that of 1979 in current dollars, in real terms (constant dollars), student assistance is back down to where it was in 1973.

Corresponding to this decline in direct aid, there has been a dramatic increase in the use of loans. Today, the average student who finances a college education with loans starts his work life between $9,000 and $14,000 in debt. We are moving toward a system of higher education in which the burden of college cost is being shifted more and more to the student and his or her family--but in the form of future costs. These concerns mean that it is time to consider alternatives which could significantly broaden and deepen higher education opportunity in this country.

One alternative is the proposal advanced by the Carnegie Foundation and others that students be given higher education grants in return for some form of national service. In many respects, this resembles the old GI bill, with the major difference being that national service would be undertaken *after* education rather than before it. Studies of the GI bill have indicated that grants provided to those who have completed military service encouraged a student to improve academic performance upon entry or return to campus, encouraged a greater sense of purpose when the student entered higher education, and clarified career objectives. Even when grants were of a relatively modest amount, they encouraged students to enroll and to persist.

Another alternative is the proposal advanced by Robert Litan, some education experts in Wisconsin, and others that, instead of giving students subsidized loans with fixed repayment schedules, the Federal Government could, in effect, take an "equity position" in a student's education by making loans whose repayment schedule was tied to the future earnings of a student. Students with high earnings would pay back more; those with low earnings would pay back less. The result would be a universal system for financing student education with greater benefits targeted to those students with lower earnings. This would end today's practice of favoring those who are fortunate enough to achieve high-paying jobs, while penalizing those who are able to earn less or who choose to earn lower salaries while providing some measure of public service. The Administration has proposed a narrower version of this basic concept, but we believe that the idea deserves a broader expression than the Administration's limited proposal.

MOVING FROM WELFARE TO WORK

An elaborate network of programs have been crafted over the years, including unemployment compensation, Aid to Families with Dependent Children (AFDC), and Workers' Compensation, which have as their goal the *maintenance* of the incomes of those who cannot find adequate work. We believe this old, "static" notion of the income maintenance system is outdated; and we need to replace it with a more "dynamic" view of income maintenance which uses these programs to *enhance* the earnings ability of people, not merely maintain their income.

This does not mean that we should turn our backs on those who are incapable of functioning on their own. For many—the sick, the dysfunctional—there is no alternative except welfare. Not many deinstitutionalized mental patients will be browsing among the want-ads for computer programming jobs or even for street sweeping opportunities. Yet we know that, for most, welfare is a second-best solution. Increasing the ranks of the dependent is not good for the recipients, for the society, or for the taxpayer.

Moreover, differences between the states regarding the size and terms of assistance may be creating serious unanticipated consequences and unequal burdens. For these reasons, we support the call for a comprehensive review of public assistance programs which will address these concerns.

We believe that our basic commitment should be to move people out of unemployment, idleness, and dependency, and into productive work. This means reforming the income maintenance system itself to place greater emphasis on human resource development.

A useful example is Unemployment Insurance. In the recession year of 1982, $30 billion was spent on unemployment compensation. Yet, four years later, a recent Office of Technology Assessment report informs us, nearly 26 percent of those who lost their jobs during that recession have yet to find new employment. All around the country, Unemployment Insurance offices are reporting an increase in the "new poor"—hard-working, well-educated heads of households who have lost their old job and have been unable to find a new one.

As the job market continues to stagnate under today's slow-growth conditions, UI becomes more of a temporary income maintenance system than a bridge to renewed earnings and independence. Today, only 32 percent of the Nation's unemployed are receiving unemployment benefits, many of the rest having exhausted benefits before finding a new job. In effect, Unemployment Insurance has become a 26-week dole to tide workers over until an upturn in the business cycle might sweep them back into the labor market. That is reasonable over the short-term, but it is not designed to lead to new employment opportunities.

We believe that the unemployment compensation system needs to be used in far more dynamic ways; to get people back to work, rather than supporting them while they wait for their old jobs to return or their benefits to run out.

In an economy undergoing immense structural change and dislocation, our present unemployment system provides an inadequate, narrow and static response. Idle workers rust, losing skills they already possess and have no means to learn the ones they need for the future. Often they have been laid off in regions where there is little or no growth, while jobs are developing in areas that are far away. They are without medical insurance or funds, and cling to familiar surroundings out of necessity. A far better approach, a dynamic approach, would begin by computerizing and expanding the Employment Service to connect workers to jobs in wider regions.

Sometime, a dynamic solution might mean offering Unemployment Insurance payments in a larger, lump sum to help facilitate a move to a new job in a new location. Experiments in Minnesota, Delaware, and California have shown significant success in helping workers find new jobs and develop new skills. Experiments in Missouri have shown how effective a modernized Employment Service can be in placing workers. In time, successes reduce the burden on public "services," restore workers to the tax rolls, and increase the productivity of the labor force. In order to extend these experiments into broader programs, however, it is important to stop conceiving of social welfare programs as private charity drawing money out of the economy, and instead reshape them as investments which can strengthen both the recipient and the society at large.

More ambitious reforms involve using UI payments as either wage subsidies, to encourage firms to hire unemployed workers, or as capital, to permit the unemployed to create their own employment. Minnesota has recently developed a wage-subsidy program which pays employers a temporary subsidy of $4 per hour to hire the unemployed. The subsidy is good for six months, at the end of which the *employer must repay 70 percent of the subsidy if the worker is let go.* If the firm is willing to retain the worker, however, the share of the subsidy which must be repaid declines each month, so that, at the end of a full year of unsubsidized employment, the firm has no obligation to repay the initial subsidy. Employers know they will get *some* subsidy even if they do not retain the worker, but they also have an incentive to create a permanent job for the subsidized employee.

Both Britain and France have embraced a novel and interesting alternative to traditional income maintenance programs for the unemployed. Instead of supporting idled workers with social insurance transfer payments, both governments have successfully experimented with helping the unemployed develop their own businesses. Such programs in effect offer *self*-employment as an alternative to *un*employment.

In Britain, the Enterprise Allowance Scheme (EAS) was set up as a pilot project in 1982, but was so successful that it was expanded to a full nationwide effort in 1983. During its pilot phase, the EAS was swamped by applications from unemployed workers with entrepreneurial ideas. When it went to a national program in 1983, with a ceiling of 25,000 slots, openings were quickly snapped up by eager workers, and the ceiling for 1984 has been raised by 35,000 slots.

The French experiment began in 1979, and was made a national program in 1980. Unemployed workers choosing to take an entrepreneurial risk can receive six months of weekly unemployment compensation, plus six months of health, disability, maternity, and life insurance. Between January 1979 and June 1982, 72,700 individuals have elected to participate in the program.

Both the British and the French programs have been dramatic successes, no matter how results are measured. Interest in the program has exceeded the number of slots available in each country. In France, between 60 and 80 percent of the businesses started under the program have survived, and well over half of the respondents credited the program itself with making their ventures a success. In Britain, 90 percent of the new businesses have survived at least one year, and 60 percent are still viable after two years. Most significantly, these new enterprises average two employees each—a significant boost to national employment for a very small investment of public money. According to the Chairman of the Manpower Services Commission, which administers the EAS program, the British Treasury will recover, in the form of increased tax revenues, the entire cost of the program plus a 33 percent additional return in the space of only three years.

Both Britain and France have discovered that it makes far more sense to *invest* in the ideas and creativity of the unemployed than to merely *spend* public welfare monies to maintain them in idleness. There is every reason to assume the same results could be obtained here. Many displaced workers presently receiving UI, for example, might be good candidates for entrepreneurship. Older workers who have been laid off or suffered partial disability are especially good prospects, for it is extremely unlikely that they will ever return to normal wage labor, and the transfer payments they presently receive are essentially "early retirement" benefits. If such workers are extremely unlikely to go off UI and back to work, then there is risk in giving them their transfer stream up front as capitalization, if they want to start a business.

A similar case can be made for reforming AFDC or "welfare." AFDC has great potential for becoming an institution which enhances both opportunity and economic efficiency. The Manpower Research Development Corporation has studied programs in states and counties throughout the United States attempting to combine work with welfare. They have discovered some clear successes which can help serve as models for the future.

Massachusetts' ambitious Education and Training Choices (ET) is one extremely promising experiment offering AFDC recipients help in job placement, training, and work experience. Although evaluation of ET is far from complete, the Massachusetts' Department of Public Welfare claims to have placed 23,000 full-time workers since October of 1983. Moreover, for each $1.00 of Federal aid, ET has reduced welfare expenditures by $2.00.

Wisconsin has created a new program to improve the collection of child-support payments. By having fathers and grandparents play a greater role in supporting dependent children, and collecting child-support payments from absent parents at their work place, it is estimated that the welfare caseload will be reduced 5 percent and the poverty gap in Wisconsin will be cut by 31 percent. This makes it possible for women to more easily get free of the constraining rules in the welfare system which penalize or discourage work. These rules have become much more of an obstacle to work in recent years, as the Administration has eliminated previous work incentives in AFDC in the name of budget cutting.

In the end, it is imperative that we stop viewing either unemployment compensation or AFDC as static grants and begin to view them as programs which can create opportunity for individuals and efficient workers for the economy. We believe these expeiments provide grounds for optimism that, in the words of AFSCME President Gerald McEntee:

> The 1980's and 1990's should be remembered as a time when all Americans joined together with government to fashion new solutions to build a full employment economy, a time when no one, however unskilled and untrained, was consigned to workfare or welfare dependency.—GERALD MCENTEE.

A major argument against such programs is cost. Investing in the development of human resources is a major undertaking. But inhibitions about cost have not prevented this Administration from making far more expensive investments in accelerated depreciation, investment tax credits, and preferential treatment for capital gains in the tax code as a means of encouraging capital formation. We believe that similarly ambitious efforts to promote opportunity through reform in income maintenance programs are investments well worth the cost. They strengthen society by strengthening the institution which underlies society—the American family.

VII. RESTORING RAPID GROWTH TO THE WORLD ECONOMY

We live in an increasingly interdependent world economy. After World War II, we were able to dominate the world economy with virtually effortless superiority. This is no longer the case. We can no longer chart economic course as though we were the only ship on the ocean. For, as with modern shipping, successful navigation depends on the development of generally accepted rules for the operation of the world economy, and effective cooperation with other nations plying the waters of international commerce.

Until recently, these concerns had been largely absent for the policies and pronouncements of the Administration, which continued to advance the view that market forces alone should deal with problems such as the overpriced dollar, the revival of world demand, and the resolution of the world debt crisis. Recently, there has been an abrupt turn in Administration rhetoric and policy, a turn toward less reliance on markets and greater reliance on public policy in promoting a stable and growing world economy. The recent Group of Five agreement on currencies and and macroeconomic coordination, the Baker plan for the world debt crisis, and the State of the Union message calling for study of the world currency system are all welcome moves toward statemanship and away from ideology.

But, while we welcome the overall change of direction, we hope that the Administration's commitment to economic statesmanship goes beyond rhetoric. The world needs to move beyond short-term bank interventions to control exchange rates to the establishment of a new international monetary system. The world needs to move beyond communiques asserting the importance of greater coordination of macroeconomic policies to a genuine sharing of the burdens of world demand growth. The world needs to move beyond a recognition that "growth' is a better solution to the debt problem than austerity to policies which will provide adequate resources to promote growth. We hope that the Administration is prepared to take these next steps.

At the end of World War II, economic statesmen in the world's major countries constructed a set of rules and institutions which helped provide stability to the world economy and ushered in an era of unprecedented growth. The United States emerged from the War with an expanded industrial capacity, while our major commercial rivals were devastated. The United Stats understood at that time that its own prosperity depended on reinvigorating the world's economies to create consumers for American goods. The Marshall Plan, the International Monetary Fund, the World Bank, and other arrangements reflected American identification with, and willingness to take responsibility for, global prosperity.

But 40 years is a long time for such institutions to endure in the face of massive structural economic changes. In recent years, these institutions have failed to sustain either growth or stability. Growth for all OECD countries in 1985 was 2.75 percent, down from 4.9 percent in 1984. The 2.75 percent growth rate is expected to be maintained through 1986.

This slowdown will only make substantially worse the problems of global excess capacity discussed earlier. In a global environment of rapid growth and expanding markets, expansion of world industrial capacity was compatible with a harmonious international trading system. Recent increases in world productive capacity, however, have come in the face of a marked deceleration of global growth.

After years of insistence that world markets would work best if left alone by government, the Administration has belatedly come to acknowledge the importance of negotiated rules and international economic statesmanship. This retreat from ideology is represented by the September 22, 1985, Group of Five agreement to support greater coordination of both macroeconomic policies and central bank intervention in currency markets. It is also represented by the President's request to the Treasury in his State of the Union message to explore the possibility of convening an international monetary conference, and Treasury Secretary Baker's new involvement in dealing actively with the world debt crisis.

We welcome this retreat from ideology by the Administration, for it provides a hopeful sign that progress toward creating a stable and growing world economy may be possible in the coming years.

THE INADEQUACY OF FLOATING EXCHANGE RATES

The old order was based on the system of international financial arrangements worked out at Bretton Woods, combined with a broad agreement on trade policy embodied in the General Agreement on Tariffs and Trade (GATT). The "Bretton Woods system" was founded on the twin principles of free trade and fixed exchange rates, and this system worked reasonably well to promote stable growth in the world economy during the 1950's and 1960's.

The Bretton Woods system started unraveling in 1971, when the United States suspended the convertibility of dollars to gold, and, in 1973, when the fixed exchange rate system was abandoned in favor of floating exchange rates. The theory behind floating exchange rates was that free trade and capital movements would prevent persistent overvaluation or undervaluation of currencies and automatically balance international trade flows. An overvalued currency would penalize exports and an undervalued currency would contribute to inflation by raising the cost of imports. Therefore, it was assumed that the problems for countries with misaligned currencies would be sufficiently serious to encourage them to adopt economic policies to produce realignment.

Unfortunately, floating exchange rates have not had this happy outcome. Combined with a communications revolution in the execution of financial transactions, floating exchange rates aggravate problems of speculation and subordinate the orderly flow of goods trade to disorderly surges of speculative capital.

On a global basis, capital flows increased almost tenfold between 1975 and 1981. The new international capital market facilitates a capital flow of about $50 trillion a year, even though only about $2 trillion a year is needed to finance investment and trade in goods and services. The rest represents speculative movements into and out of different currncies to make a profit out of short-term exchange rate shifts.

Open markets and rationalized trade rules cannot solve the problem of huge trade imbalances if exchange rates are allowed to became severely misaligned as a result of unregulated financial flows.

The most obvious problem in the current system is the massive and persisting overvaluation of the dollar. The misalignment in currency values and volatility of exchange rates had a severe impact on the U.S. economy and international trade. We join the many experts in believing that the current "nonsystem" of exchange rates has failed and needs to be reformed.

Such reform must proceed at a number of different levels. At the most superficial level, it is important that international monetary authorities play an active role in maintaining stable exchange rates and preventing any persistent overvaluation or undervaluation of a currency.

The actions announced in September by the Group of Five provided a dramatic signal to financial markets that the Administration now considered the overpriced dollar a problem, not a source of national pride. The success of the September meeting was marked. Exchange markets instantly responded, as the dollar fell by some 13 percent in a matter of weeks. We believe the United

States should continue its willingness to participate in such international missions to restore needed stability to currency markets.

However, we recognize that central bank intervention can only work in the short run. What began with the Group of Five is less a solution than a first step back toward a more stable system, such as the one that began to take shape at the 1944 Bretton Woods conference. We welcome the Administration's apparent shift of position on the need for a new Bretton Woods conference and urge the Secretary of the Treasury to move ahead swiftly with the process of establishing the groundwork needed to make such a meeting a success.

While our fundamental view is that the present exchange rate system is indeed "broke" and in need of substantial restructuring, we recognize that creating a new system needs to be a matter of negotiation among the major trading and currency nations. In the course of such negotiations, the Administration should carefully consider:

(1) Establishing "target zones" for the major trading currencies. There are a number of proposals receiving active attention which call for setting limits to the fluctuations of major currencies. When currency values start to stray beyond these agreed-upon zones, the countries should use both fiscal and monetary measures to bring their currencies back into line.

The advantage of such fixed and announced limits is that they reduce the uncertainty facing importers and exporters that exchange rate fluctuations will overcome their profit margins, and this would contribute significantly to increased order and stability in world trade.

We recognize that there are serious problems with establishing target zones, chief among them being the reduction in macroeconomic autonomy which such a system entails. But, over the long run, we think it likely that the "target zones" combine many of the best features of the old fixed-rate regime with the flexibility of limited market movements in currency values. Because we are concerned about the rigidity of completely fixed exchange rates, we are opposed to a return to some commodity standard (such as gold) to which all currencies should be pegged.

(2) Expanding the rule of other currencies as stores of value and intermediaries for world trade. International monetary relations are immeasurably complicated by the fact that the U.S. dollar is the reserve currency of the world. Because of this unique status, the dollar can fluctuate in value not only independent of U.S. trade balances, but independent of capital balances as well. We believe this situation may well be untenable over the long run, and that the world economy may have to develop new forms of international currency reserves. Options in this area include an expanded role for IMF Special Drawing Rights or making greater use of baskets of weighted currencies.

The creation of a viable form of new international reserves is a long-term proposition, but the health of the world trading system could well depend on a consideration of this issue. We urge the Secretary of the Treasury to include an investigation of this issue in his review of international monetary policy.

MACROECONOMIC COORDINATION

But, while reform of the exchange rate system is urgently needed, changes in currency relations alone may not be sufficient to restore rapid growth in the world economy. Since the world has become far more interdependent in recent years, there is far greater need for coordination of macroeconomic policies, both monetary and fiscal, among the world's major trading nations.

On the monetary side, it is clear that the task of devising a new exchange rate system would be greatly facilitated by a greater degree of coordination in interest rate policies of the major nations. Widely disparate interest rates distort international capital flows as investors move money into securities with high yields regardless of the health of the economy in question.

On the fiscal side, the experiences of the United States in the late 1970's and France in the early 1980's demonstrate that traditional national Keynesian demand stimulus policies have been weakened by international leakages. This was a particularly serious problem for the United States in the recovery from the 1981-1982 recession, when foreign imports offset a large part of the increased demand. Imports were especially important for American capital goods markets during the 1981-1984 business cycle, when 95 percent of the increased demand for U.S. capital goods during the recovery was met by imports.

Since 1982, American fiscal policy has been highly stimulative, and monetary policy moderately expansive. Simultaneously, Germany and Japan have pursued very restrictive policies. Normally, this scenario would generate a boom here and a severe recession in the two countries. However, with Germany and Japan generating excess savings that could not be absorbed by their domestic economies, the savings have flowed to the United States where they were readily absorbed in financing our budget deficit.

Due to the exchange rate factor, these countries were able to have much higher growth than their restrictive policies should have permitted. This situation is both untenable and undesirable.

It is untenable because the United States is, properly, committed to reducing its huge budget deficit. In an interdependent world, deficit reduction by the United States represents the withdrawal of demand stimulus from the world economy. Without some countervailing increase in stimulus from other major nations, the problems of overcapacity and insufficient world demand mentioned earlier could help shove the entire world economy into a recession.

The United States and other countries must coordinate their economic policies to promote sustained worldwide growth. This requires immediate steps by other developed countries to stimulate their economies through less restrictive fiscal and monetary policies. In this regard, we note the recent recommendation of Morgan Guaranty Trust Company that:

> What is needed is a cautious swing—away from the inflation-fighting preoccupation of the last several years—in favor of expansionary policies for the future.—THE MORGAN GUARANTY TRUST COMPANY.

Other industrialized nations need to assume far greater responsibility for maintaining global economic growth, or the likely result will be a recession in the United States and throughout the world. The drop in oil prices provides these countries with an historic opportunity to stimulate their domestic economies. Historic fears about inflation should be put to rest by the favorable development in oil prices, and conditions appear ripe for a major expansion abroad.

Unfortunately, there seem to be few signs that other major powers are accepting the responsibility for a revival in world demand. The German Finance Minister has told his Parliament that the government has no intention of bowing to pressure to stimulate the economy further, despite the fact that Germany is experiencing zero inflation and 9 percent unemployment. A tax cut scheduled for 1988 is not being pushed forward, and, although German monetary authorities have recently taken some steps toward lower interest rates, more could be done. With high German interest rates, companies all over Europe find it more profitable to keep money in financial assets than to undertake new investment in plant and equipment.

Japan isn't doing much better. The Japanese stimulative package announced in mid-October of 1985 is expected to have a very limited effect. Some of the spending announced was already in the pipeline, and, in other cases, funds were merely shifted from one project to another. The program's additional impact has been estimated at no more than 0.5 percent of GNP over two years. Prime Minister Yasuhiro Nakasone and the Finance Ministry remain obsessed with Japan's large budget deficit, which amounts to 4 percent of the gross national product. They are staunchly opposed to hiking government spending to boost the economy. In addition, many Japanese businesses are anticipating a slowdown in the near future, creating a self-fulfilling prophesy, as management holds down workers' year-end bonuses. Lower expectations for take-home pay will depress consumer spending, which has grown only half as fast as Japan's entire economy over the past five years.

The drop in oil prices has weakened British exports and the British pound. In an effort to defend the pound, British banks raised their base lending rate to 12.5 percent from 11.5 percent of January 8 of this year. Some London bankers think rates may have to go even higher to forestall a rise in inflation. That could dampen Prime Minister Margaret Thatcher's hopes for growth of 3 percent or better this year, and reduces the chances that Britain will play any significant role in the revival of world demand.

Whichever party rules after the election, France is likely to continue its efforts to reduce inflation and hold down public expenditures. Like the British, the French seem to believe it is more important to defend the currency than to stimulate growth. The most recent indication from the French Finance Ministry is that the country has set aside $17 billion in currency reserves to defend the franc.

It seems clear to us that other countries need to shift their basic macroeconomic policy mix in a more stimulative direction. West Germany should move to lower interest rates, permitting the rest of Europe to follow. A decline in German interest rates would permit the Federal Reserve to engineer a similar decline of like magnitude in U.S. interest rates to keep the dollar from appreciating. Lower rates here and abroad mean greater economic growth, a less painful path toward domestic deficit reduction, and easier terms for debtor nations.

Japan usually reflates by encouraging business to invest, which helps modernize production for the next export push abroad. Such an approach would probably only aggravate the problem of Japanese trade surpluses, and put further strain on the world trading system. Instead, Japan should be encouraged to stimulate its economy through new incentives for consumer spending. What the world economy needs at this point is a growing Japanese market for consumer goods, not a continuation of new investment by business.

A combination of easier monetary policies in Europe and expansive fiscal policies in Japan could make a major contribution toward restoring both growth and balance in the world economy. If these countries are reluctant to take such steps on their own, we urge the Administration to expert political and economic influence on our allies to take the required action. The Administration has been very forceful in getting our allies to accept and endorse our strategic policies. Similar efforts are required on the economic front.

We believe that the United States is in a surprisingly strong position to insist on fact action. An American commitment to reduce our huge budget deficit satisfies one of the long-standing complaints of our trading partners. Having met our side of the bargain, it is time to ask that our allies keep theirs by picking up the slack in the world economy which deficit reduction here will create.

INTERNATIONAL TRADE: IMPROVING OLD LAWS, WRITING NEW RULES

Currency reform and better macroeconomic coordination will not solve all of the problems in the world economy. There remains the stubborn and difficult issue of trade.

We believe that the volume of world trade should expand rapidly, for rapid growth provides the momentum to carry all countries over the difficult problems of structural adjustment which open trade requires. We believe in the "bicycle theory" of trade: that, unless there's ongoing momentum towards greater trade liberalization and trade expansion, trade progress tends to stall, and nations pedal backwards. Certainly, the last few years have provided ample evidence of the continued relevance of this theory, as virtually all nations have raised a variety of unilateral barriers to trade and adopted trade tactics outside the established rules and norms embodied in the GATT.

In this environment, we believe it is essential that the Congress work swiftly toward reform of America's outdated trade laws. We believe there is a need for faster and more effective mechanisms for sanctioning unfair trade practices which harm American firms, including faster turnaround times for decisions, broader and more realistic definitions of unfair trade practices, and a greater reliance upon government self-initiation of trade action. We also believe that new mechanisms need to be put in place to impose greater conditionality on trade relief which is granted in order to facilitate orderly adjustment and modernization by American industry. We believe that trade relief justified in the name of "facilitating modernization" should in fact lead to modernization and enhanced competitiveness for the aided industry. Present practice all too often turns trade relief into a "free lunch" for the aided industry, with no substantial modernizing effect. Finally, we believe that greater efforts need to be made in the area of export promotion, for as the discussion of our trade problem in an earlier section of the Report indicated, slow export growth is a major cause of our deteriorating trade balance.

But, in addition to these domestic reforms of our own trade law, we now are faced with an excellent opportunity to reverse the trend towards greater protectionism and reestablish a trading system governed by rules which all countries respect and from which each country gains. A group of the contracting parties to the GATT is presently meeting to discuss the issues which will be negotiated in a new round of trade liberalization talks. Assuming sufficient progress is made, a ministerial meeting will take place early in the fall to launch a new round.

For a new trade round to be useful, it must focus on the following areas: elimination of agricultural export subsidies; extensions of GATT rules to cover services, investment, and intellectual property rights; development of rules to discipline the negative effects of certain practices not covered by the GATT, including natural resource subsidies, upstream subsidies, and downstream dumping; and measures to strengthen the GATT as an institution and its ability to settle trade disputes.

In the process of negotiating new trade rules, some attention should be given to the possibility of establishing basic international labor standard principles to minimize the negative impact of economic competition on labor standards in the industrialized countries, while making it possible for third world workers to improve their wages and working conditions through democratic means. Today's pattern of global competition based on driving down wages and limiting the power of workers is not desirable from the perspective of workers in either the developed or the developing world. Although quantitative global wage standards would be unrealistic, labor standard principles should include matters such as occupational safety and health, freedom of association, and freedom from forced labor. Such standards for labor not only would protect workers from exploitation but also would help overcome resistance to an open and expanding international economic system.

With these priorities in mind, the Administration should press forward with efforts to ensure a successful new trade round. The domestic U.S. market presents a huge and lucrative opportunity for our trading partners. They should be made to understand that, absent their cooperation in negotiating substantial trade reform and liberalization, access to this market is in jeopardy.

THE THIRD WORLD DEBT CRISIS

The third world debt crisis is one of the most difficult and persistent of the world's economic problems. Over the past few years, attempts have been made to "manage" the debt crisis through austerity and export promotion in the debtor countries. There is now a widespread recognition that this strategy is no longer viable, and we welcome the recent shift of emphasis in Administration policy towards growth, not austerity, as the solution to the world debt crisis. But there is some reason for concern that existing Administration initiatives may not be adequate to the task at hand. It may have underestimated the size of the problem, particularly in light of the recent oil price decline; it may have failed to mobilize the needed commitments from the banks; and it may have overestimated the efficacy of "supply-side" initiatives in the debtor nations. If the world is to do more than merely postpone resolution of the debt crisis, steps are going to have to be taken soon to deal with the debt service problems of the debtor nations. We hope the Administration is prepared to recognize this reality and to develop proposals adequate to the challenge.

The origins of the debt crisis lie in the peculiar economics of the late 1970's, when oil price increases created a vast pool of "petrodollars" which needed to be recycled into productive investments and when American financial institutions sought to escape domestic interest rate regulations and earn high profits abroad.

Driven by these forces, capital markets allowed developing countries, particularly those in Latin America, to pile up huge debt burdens which were far beyond the capacity of their economies to service. Even when the world finally acknowledged the reality of the "debt crisis," financial institutions continued to extend new credit to debtor nations. Lending to Latin America, for example, grew by over $97 billion between 1980 and 1982, at a time when it was clear that these countries could not even service their existing debt, much less take on new commitments.

In response to the buildup of debt, it has been the policy of the United States and other creditor nations to deal with the debt crisis by loan reschedulings, IMF stabilization missions, and other practices to encourage debt repayment through a combination of domestic austerity and rapid export growth. While this solution might have worked in a growing world economy, the recession in the United States and high world interest rates made this approach bad for the U.S. economy, bad for the economies of the third world, and potentially dangerous for the international economic system as a whole.

It was bad for us because the strategy forced Latin American countries to reduce their imports from the United States. Consequently, U.S. exports to Latin America have declined from $39 billion in 1981 to $26.3 billion in 1984 as these countries restricted imports to husband those dollars needed for debt service and recession cut demand for foreign goods. While U.S. exports to Latin America have declined, U.S. imports from the region have increased sharply from $32 billion in 1981 to $42.3 billion in 1984. A trade surplus of $7 billion has become a $16 billion deficit. By some estimates, the United States has lost about 800,000 jobs as a direct result of the Latin American debt crisis, reducing our national output by as much as 1 percent.

Between 1981 and 1984, the debt crisis caused a bigger deterioration of the U.S. trade deficit than did imports from Japan. Latin

American agricultural exports may be driving down commodity prices and driving U.S. farmers closer to bankruptcy.

Austerity and export promotion have also been bad for the vast majority of Latin American debtors. Per capita income in the debtor countries has fallen by 20 percent from its 1980 level, putting incredible strains on the fragile democracies which are beginning to emerge in the region. And, although the debtors as a group are poor countries by world standards, they have been paying back about $30 billion to $40 billion a year in net-resource transfers, or an amount equivalent to 6 percent of their GNP. These net capital transfers prevent the development of internal markets in these countries, stifle domestic investment, and severely constrain economic growth in the region.

But, perhaps most important of all, the debt problem could prove devastating for the entire world economy. The last major debt crisis confronting the world was the German reparation crisis of the 1920's and early 1930's. Then, the international creditors took the position that Germany must pay war reparations in full to make it possible for the European allies to repay their war debts to the United States. This "austerity" approach to the World War I debt crisis contributed to a rapid deterioration in German living standards, the rise of Hitler, the collapse of world trade, financial panic, the Great Depression, and the outbreak of World War II. The present world debt situation contains much of the same potential for global crisis, especially given the twin problems of debt and demand noted earlier in this Report.

These factors have been slowly leading to a realization by all concerned that the debt strategy put into place after the Mexican crisis had essentially run its course. The political will to maintan austerity was severely eroded, the U.S. economy was slowing and protectionism rising, and the commercial banks weren't resuming voluntary lending as had been anticipated. There was general agreement that something had to be done to revitalize the process. And, in the face of this general agreement, Treasury Secretary Baker announced a major shift in Administration policy away from austerity and toward "growth" as a solution to the world debt crisis.

THE BAKER PLAN

The plan announced by Secretary Baker for a reorientation of U.S. and world policy toward the debt crisis represents a long overdue recognition that austerity is no solution to the debt crisis. Instead, the Baker plan announced that "growth" should be the key to resolving the debt problem. To promote growth, debtor nations would be asked to make changes in their economic structure, banks would be asked to resume lending to debtor countries, and multilateral financial institutions, such as the World Bank, would inject new long-term credit into the ailing debtor countries.

As a shift of strategy and emphasis on the part of the Administration, we believe that the Baker plan was a positive step in the right direction. It may not, however, be an adequate solution to the world debt problem. There are three reasons for this concern. First, the dimensions of the problem may have been underestimated, particularly in light of the recent decline in oil prices. Second, it is unclear whether the Baker plan has the support of either the American or the international banking community. Third, the plan's emphasis on "supply-side" reforms in the debtor nations may not produce the desired or anticipated results.

The Size of the Problem: The Baker initiative appears to involve some \$9 billion of new long-term lending by the World Bank which is designed to induce some \$20 billion in new lending by commercial banks. There is a legitimate concern that, even in concept, this is an adequate amount of capital to commit to a resolution of the debt crisis, in light of the fact that the fall in oil prices has created a need *in Mexico alone* for some \$8 billion and \$9 billion of new lending. If the other oil-exporting countries are factored in, it would appear that the entire new lending commitments envisioned in the Baker plan could easily be absorbed in simply compensating for the oil price decline, with no new developmental effect at all.

The Support of the Banks: It is obviously true that there has been no outpouring of new loans by the banks since Secretary Baker's September announcement. In fact, the only recent statement which the banks have made to Congress concerning the debt situtation came in testimony by George Clark, Executive Vice President of Citibank, on the President's tax reform proposals. As reported in the *Washington Post,* Clark said:

> That a provision in the legislation cutting back on foreign tax credits for taxes on interest earned from international loans could undermine the proposal made by Treasury Secretary James A. Baker III, to have banks increase their lending to third world nations by \$420 billion.
>
> Without the strong support of the U.S. banks, the Baker initiative is going nowhere.—GEORGE CLARK.

In light of such statements, the Baker plan may indeed be "going nowhere" until the Administration manages to persuade the banks that the plan is a serious policy initiative, not merely a useful tool for banking lobbyists on Capitol Hill. And time is fast running out for such a reorientation on the part of the banks. Without some obvious new lending in the near future, we are worried that the debtor nations will adopt a unilateral solution to the debt crisis which could seriously destabilize world financial markets.

In this context, we note the concern of Robert Hormats that:

> Unless there's a tangible success soon, the plan could go down the drain.—ROBERT HORMATS, Goldman, Sachs and Co.

The Wisdom of a "Supply-Side" Approach: While problems of loan volume and bank participation could be merely transitional problems attendant upon any new enterprise, the Baker initiative may have a deeper flaw in that it is based on a too broadly applied assumption about economic growth and structure in the developing world.

At its core, the Baker plan is counting heavily on having debtor countries grow their way out from under their debt burden by simply unleashing the forces of private enterprise. This is precisely the same kind of "supply-side" economics which has so far proved disappointing in managing debt or increasing U.S. growth dramatically. In light of this evidence, there is little reason to anticipate a "supply-side" miracle in the debtor countries when none was forthcoming here. In this, we note the observation of American Enterprise Institute economist John Makin that:

> You're not going to take $29 billion and transform them into supply-side miracles.—JOHN H. MAKIN.

A major reason for expecting only a small payoff from the "supply-side" portion of the Administration's initiative is that such an approach fails to recognize the substantial variation in economic conditions in the debtor nations. In some regions (Africa, for example), some governments have indeed become too much of a presence and stifled private initiative. In others (such as Central America), the reverse is true, with governments too weak to provide stability to economies dominated by selfish and irresponsible private economic elites. With so much diversity, a single economic strategy is unlikely to produce uniformly positive results in enhancing growth or preventing the growth of revolutionary movements antithetical to Western interests.

But there is another, more fundamental reason for questioning the wisdom of a predominantly "supply-side" approach to the world debt crisis. In today's world economy, there is some danger that a focus on supply-side initiatives as a solution to the world debt problem could aggravate the already serious problem of world demand mentioned earlier in this Report.

In a hearing before the Committee, Assistant Secretary of the Treasury David Mulford made a remark which may summarize the "supply-side" orientation of this Administration:

> If . . . there was a greater dependence upon supply-side actions to mobilize savings and foster more efficient investment in these economies and market-opening measures of the type I've mentioned, you would, in my opinion, get the kind of grassroots economic development that we have already seen in many Southeast Asian countries, where the model is clearly towards giving free-market forces some reign.—DAVID MULFORD.

If this statement fairly represents Administration thinking on the third world debt situation, then it would appear that the Administration hopes to turn the debtor nations of Latin America into vigorous exporters like the newly industrializing countries of East Asia. But would the world really be better off if Latin America resembled East Asia?

An earlier section of this Report noted that the East Asian development model is focused heavily on export promotion. Domestic demand is held down by both economic policy and political power, and the countries achieve their rapid rate of growth in GNP largely by making products for export to the United States' market.

As a result of these policies, the United States ran a per capita trade deficit with the four principal East Asian countries (Taiwan, Singapore, Hong Kong, and Korea) of $271 in 1984. At the same time, our per capita trade deficit with all of Latin America (excluding Mexico) was $21. If Latin America were to follow the same growth strategy as East Asia, and were as successful at it, this would imply a tenfold increase in our trade deficit with Latin America. An increase in our trade deficit with Latin America from $16 billion to $160 billion would clearly solve their debt problem, but it would only contribute to our own trade crisis and the world problems of excess supply.

BEYOND THE BAKER PLAN

The Baker initiative points the way toward an eventual resolution of the debt crisis. Its focus on growth instead of austerity is welcome, and we agree with its emphasis on new capital inflow to the region. We also agree with its emphasis on structural reforms in debtor economies, although there may be far less potential in this initiative than the Administration predicts.

But a long-run solution to the world debt crisis may require action on the demand side of the economic equation, as well as on the supply side. Proposals made earlier in this report on international macroeconomic policy are an essential foundation for any realistic solution to the third world debt crisis. We will need to get growth up, and interest rates down, in the industrialized world in order to make any lasting progress on the debt problems of the developing world.

If the developed world does not manage this revival of world demand, then it may be the case that more direct steps will be needed to reduce the debt service burden on developing countries. In this context, we note the testiomny of MIT economist Stanley Fisher, who told a recent Committee hearing on the Baker plan that the Latin American debtor nations have:

> . . . restricted domestic demand very sharply. They've got deep recessions and the plans that Mr. Mulford is talking about are ones which will enable them to increase supply. They've got to be able to handle demand for the next few years and they actually need more. The need a reduction in their burden to enable them to reach the stage where the United States' hoped-for reforms come into effect.—STANLEY FISHER.

We recognize that reducing the burden of debt service is a difficult problem, involving conflicting interests of creditors and debtors. But we do not believe it does anyone a service to ignore the problem and assume that some miracle of growth is going to relieve us of the necessity of coming to grips with the issue of debt service relief.

Therefore, we urge the Administration to explore proposals for reducing the debt service obligations of the major debtor nations at the same time that proposals for new lending move forward. Although movement in this direction will clearly be difficult, we believe that a broad view of our own self-interest requires that the United States and other developed countries pay more attention to demand growth, debt service relief, and the development of democratic institutions in the developing countries.

VIII. MEETING THE CHALLENGE OF COMPETITION

The American economy is facing an unprecedented set of new challenges from foreign competition, yet our government is failing to develop the kinds of policies which will be required to win in the newly competitive world marketplace. We cannot passively assume that our trade problem will vanish when and if the dollar comes down. For our task is not merely the reduction of our existing trade deficit, but the far more difficult task of transforming the deficit into a surplus so that we may pay off our creditors. Bringing about this transformation will require effective policies to focus attention and resources on the competitiveness problem. We will need to reform our policymaking institutions to deal with competitiveness issues; we will need to improve the quality of our work force; and we will need to make improvements in both public and private investment in a competitive America. All of these changes are essential if we are to compete effectively in the world market, and far too many of them are being ignored by current policy.

What was once described as "America's trade problem" is fast becoming "America's trade crunch." Because we have financed our recent trade deficits with borrowing, we must earn a surplus, not just break even. At present trends, the U.S. external debt would be over $1 trillion by 1995; interest on this debt could be over $100 billion a year. The United States must, therefore—eventually—earn a trade surplus which could approach 1.5 percent of GNP merely to service our foreign debt obligations.

To achieve this surplus, the United States is going to have to reverse a long decline in our trade balance in one key area, *manufacturing.* Although analysts frequently point out that the United States has long ago become "a service economy," it is less frequently noted that services make very little contribution to our trade balance. In this analysis, note that Lionel Olmer, a former member of the current Administration, observed recently:

> . . . To bring down the deficit, it will be essential that the U.S. experience a sizable surplus in manufactures trade, simply because a surplus from any other source isn't likely: the United States will of necessity remain dependent on importing various raw materials and petroleum (which has equaled roughly half of the trade deficit); it cannot expect a significant increase in the surplus of agriculture exports (the existing surplus is by no means assured); and growing interest payments on America's foreign debt is eroding its position as a net exporter of services.—LIONEL H. OLMER.

But, if the responsibility for producing a trade surplus must fall on the manufacturing sector, it is essential that we recognize that American manufacturing faces a serious lack of competitiveness in both American and world markets. This lack of competitiveness is frequently obscured by two arguments, both of which we believe are incorrect: that the problem is entirely the value of the dollar; and that the problem is entirely one of "unfair trade" abroad.

THE DOLLAR

As we noted in an earlier section of this Report, we believe that the dollar is a major problem for the American economy, and we believe that steps ought to be taken to remedy its overpricing. And although we hope that progress toward deficit reduction and progress on international monetary reform will result in a significant change in the dollar's value, we are concerned that our trade problems will not disappear when the dollar returns to a more normal alignment with respect to other currencies.

In this context, we note the analysis of the President's Commission on Industrial Competitiveness which found that:

> While the strong dollar has contributed greatly to the trade deficit, our competitiveness problem is much broader. Our slow productivity growth, stagnant wages, and high capital costs are not caused by the strong dollar. Thus, the fall in the dollar, if it occurs, will not solve the long-term problem. A lower value for the dollar did not cure the trade deficit in the 1970's, when, despite a 15 percent depreciation, our trade deficit actually increased.—PRESIDENT'S COMMISSION ON INDUSTRIAL COMPETITIVENESS.

We believe there are four basic reasons why a repricing of the dollar will not solve our competitiveness problem. First, the overvaluation of the dollar over the past year has changed significantly the market position of foreign firms. They have captured markets formerly controlled by American firms, and are likely to be willing to pay a substantial price to hold on to those markets in the face of a declining dollar.

> . . . during periods of slack demand, much less during a recession, U.S. companies will be hard pressed to retain their existing markets, much less recapture what they have lost to foreign suppliers, many of whom have invested heavily in developing strong and lasting relationships with their U.S. customers.—LIONEL H. OLMER.

If the dollar should come down in value, many firms would prefer to maintain market share and absorb the devaluation in their profit margins rather than let American firms regain market share. This seems to part with what is happening in regard to international trade in autos. Although the dollar has declined by roughly 20 percent since the summer, Japanese auto firms have announced price increases which fall substantially below that figure. Mitsubishi raised prices 3.7 percent, Toyota 3 percent, Mazda 4.8 percent, and both Nissan and Honda repriced only 4 percent.

Second, a significant portion of our trade deficit comes from countries whose currencies are closely tied to the dollar. The major East Asian newly industrializing countries (Taiwan, Singapore, Hong Kong, and Korea), for example, peg their currencies to the dollar, and Canada, a major source of our trade deficit, has not seen a great depreciation of its currency relative to our own.

Third, we believe that many American firms have changed the way they view the process of production and marketing. They see a world in which protectionist sentiment is on the rise everywhere, and they have a strong self-interest in locating production facilities throughout the globe to prevent themselves from being excluded from key markets, sources of raw materials, or skilled workers. This had led to a rapid "globalization" of production which is unlikely to be reduced by a decline in the value of the dollar. Investment by U.S. companies in their foreign affiliates has expanded fourfold over investment in domestic activities in the past year. Firms are increasingly "outsourcing"—buying components from abroad instead of from American suppliers.

Several commentators support this general observation:

> Until now, most of the growth in imports has come from foreign-based corporations—however, more U.S. companies are now beginning to shift production overseas, suggesting that substantial increases in imports from foreign operations of U.S.-based companies, and more sluggish U.S. exports, are likely.—CHASE ECONOMETRICS.
>
> More and more business firms are beginning to realize that, while the America economy is an excellent place in which to sell, it is a very poor place in which to produce.—BARRY BOSWORTH.
>
> Most companies haven't still fully shown up yet, their outsourcing of recent years. It hasn't fully shown up in the trade data.—LAWRENCE CHIMERINE.
>
> The modern notion is to maintain product engineering and development in the United States on computer-aided design facilities and then to use long-distance telephone lines in order to communicate those design facilities directly into dispersed manufacturing operations in the sources of major markets.—MICHAEL PIORE.

Finally, we believe that the overpricing of the dollar may have done permanent damage to many of our most trade-sensitive sectors by generating a "vicious circle" in which competition from abroad limits profits, profits limit investment in both physical and intellectual capital, and inadequate investments in turn lead to lowered product quality, lowered sales, and still lower profits.

> . . . this is not easily reversible, even if the dollar should come back down again. This history has been that, when companies fall behind their competitors and they take on a lot of debt and they have to abandon their research and development, it is almost impossible to catch back up again. There are very few examples of major corporations that have ever turned around and come back to lead a market once they fell behind.—BARRY BOSWORTH.
>
> One of the most ominous developments for the future of America is the speed with which the Japanese are taking over the markets of the rapidly industrializing countries: Brazil, for instance, or India. They do so because they can invest in the distribution system in these countries in anticipation of the future market. American company managements are perfectly aware of this. But, when asked why they do not do likewise, they tend to say, "We cannot

> afford to set aside this money and invest it in tomorrow. We need it to make a good showing in next month's or next quarter's profits."—**Peter F. Drucker**.

From this perspective, what was good enough to keep a company or a country ahead is not nearly good enough when you are behind.

UNFAIR TRADE

The second major rationale for ignoring our competitiveness crisis is the argument that our trade problems in manufacturing stem largely from unfair trade practices abroad.

We believe strongly that unfair trade practices abroad *do* exist, they they *are* serious problems for American industry, and that the Administration has been timid and tardy in dealing with the regrettable trend toward mercantilism as a trade strategy in much of the world, with governments deliberately closing markets or unfairly promoting the interests of their own industries in pursuit of national economic advantage. Such trends are dangerous to the stability of the world trading system, and must be addressed.

We believe that reforming our domestic trade laws and seeking new international rules governing trade are important initiatives which must be pursued. But, beyond that, we caution against the comfortable assumption that our trade problems will vanish if we somehow managed to remove all foreign trade barriers. In this, we note the views of both Lionel Olmer and Barry Bosworth on the unfair trade issue:

> If all the markets in the world were open on an equitable and balanced basis, and no nations were permitted to sell products at prices below fair value or with the benefit of government subsidies, it would merely dent—by less than 10 percent over several years—the $140-$150 billion trade deficit; it certainly would not immobilize its negative movement.—**Lionel H. Olmer**.
>
> The problem with trade for the United States in world markets is simply not trade restrictions by other countries. . . . If other countries such as Japan should in fact liberalize their restrictions that they have on imports, it is not the United States that would benefit. It is other industrial countries that would again find that they could outcompete us in terms of the prices that they would offer Japanese consumers.—**Barry Bosworth**.

On the basis of this evidence, we see no reason for complacency with regard to America's international trading position, and no reason to ignore the domestic sources of our competitiveness problem.

FACING UP TO THE COMPETITIVENESS PROBLEM

We believe that American industry has a serious competitiveness problem which must be met with a serious competitiveness policy. We need to recognize that we live in an increasingly competitive world in which most of our competitors practice aggressive strategies to win economic advantages for their own firms.

> Government is too much of a factor, too many parts of America will be disadvantaged by ignoring the roles of foreign governments.—**Kevin Phillips.**
>
> The Japanese maximize market share and our people maximize short-run profits.—**Ray Marshall.**
>
> I was struck at the extent to which other countries are committed and believe and care about being competitive in the world economy.—**Jerry Jasinowski.**

We must not assume that foreign industrial policies are some sort of aberration, a temporary deviation from the "correct" principles of laissez-faire, free-market economics. Practitioners of industrial policy do not see their activities as a means of abandoning the market in favor of planning, but as a way of strengthening the operation of market forces and defending our true national interest against those who seek to manipulate or warp market forces.

> While we might hope that the Japanese would agree to play the game of international competition by our rules, they have no reason to do so, for they perceive that they are winning the game using their current strategy.—**Robert N. Noyce**, Vice Chairman, Intel Corporation; and Chairman, Semiconductor Industry Association.

In such a world, we have a national *economic* interest which is just as much in need of defense as our more familiar political and stragetic interests. Yet, while this Administration is prepared to go to virtually any lengths to promote what it sees as our strategic interests, it has almost completely ignored the crucial issue of our international competitive interests

A COMPETITIVENESS STRATEGY: THE UNFINISHED AGENDA

There is wide agreement across the spectrum of opinion in this country that we have a serious competitiveness crisis which must be met with a serious competitiveness strategy. A few examples should be sufficient to make the point:

> American industry has a competitive problem.—**John Young**, Chairman, President's Commission on Industrial Competitiveness.
>
> The answer to the U.S. trade deficit is that there is not a single, adequate policy response to the accumulated imbalance and its affects on U.S. manufacturing. It will be necessary to "fix" a number of things which haven't worked or which are acknowledged without argument to be unsatisfactory.—**Lionel H. Olmer.**
>
> We've got to really come up with a pretty sweeping agenda of commitment to the competitiveness crisis.—**Kevin Phillips.**
>
> And what I would argue is that a competitive strategy requires action on the macro front as well as action on the firm front as well as action with respect to microeconomics, and that what we should be concerned about at this point is developing again a consenses on a competitive strategy overall.—**Jerry Jasinowski**, National Association of Manufacturers.

An increasing number of observers are coming to the conclusion that only effective public policy can effectively pursue our national interests in international competition. In our kind of economy, corporate executives must primarily be responsible to their stockholders, not to the citizens of any country in which they do business. If firms are committed to promoting the interests of the *firm*, then it must be government policy which is committed to promoting the interests of the *nation*. As Lester Thurow points out:

> Americans often think that private American firms will do whatever strategic planning is necessary for the American economy to be successful and that as a result government has no role to play. Private firms simply will not do what is necessary. In a very real sense, there are no private American firms. There are firms legally headquartered in America but they can locate their research and development, office, or production facilities anywhere in the world. Per se, they have no direct company interest in the success or failure of the U.S. economy. They only have a direct interest only in their own success and failure. Often it is cheaper for an American based company to simply move production or engineering abroad than it is for it to make its American operations competitive. Yet foreign production is not a solution to American growth problems even if it is a solution to the competitive problems of American based companies. If economic strategies are necessary for the United States to be successful in world markets, they are going to have to be developed with the impetus of government leadership or they will not be developed.—LESTER THUROW.

This underlying consensus has been revealed not only in testimony before the Committee, but in a large number of reports, studies, and commissions which have examined the issue. Virtually all of these calls for an effective competitiveness strategy by government have been met with the same response from the Administration—silence.

It is easy to understand the motivation for the Administration's position: to acknowledge the need for a public response to the competitiveness crisis would be to acknowledge the need for government, and it is an article of faith of this Administration that there is no role for government except protecting the country from attack and keeping order among the citizens.

But we believe the competitiveness situation in this country is a task similar in scope and import to the task of assuring adequate national defense. Too narrow a definition of "national defense" could in fact jeopardize our ultimate security, for, as the experience of World War II demonstrated, the ultimate military advantage belongs to the side with the greatest ability to mobilize economic power for a prolonged conflict.

For this reason, we believe that it is extremely important for the Administration to give more than a nod to the realities of international competition.

Should the Administration choose to face up to the competitiveness crisis, the task of developing effective policy responses to this challenge will be made immeasurably easier by the backlog of existing recommendations already on the table. Because the consensus behind the need for a response to the competitiveness crisis is so strong, there is a vast "unfinished agenda" of recommendations whose implementation await only a decision by the Administration to come to grips with the issue.

In light of this long unfinished agenda, we would like to close this section of the Report not with a list of new initiatives but with a review of those which have received too little attention and action from the Administration.

FOCUSING POLICY ACTIONS ON THE COMPETITIVENESS PROBLEM

The cornerstone of past recommendations has been the creation of some formal mechanism for introducing the competitiveness perspective into national policymaking. The specific form of such an institution has been open to debate: the White House Conference on Productivity called for the establishment of a National Industrial Policy Board; and the President's Commission on Industrial Competitiveness called for both a competitiveness advisor in the White House and the creation of a cabinet-level Department of Trade. The Business-Higher Education Forum recommended an annual executive branch report on U.S. foreign economic policy; and the Committee for Economic Development recommended a comprehensive strategic review of the entire range of government economic policies.

What is not open to debate is the need to do a far better job of coordinating our broad range of diverse policies into an effective strategy for improved competitiveness. We strongly recommend that the Administration follow through on the task of creating some effective mechanism for introducing the competitiveness issue into national policy deliberations.

IMPROVE INVESTMENT, BOTH PUBLIC AND PRIVATE

Statistics on savings and investment cited earlier in this Report describe the basic dimensions of our investment problem. We have a low savings rate; we have a high government dissavings rate (in the form of the Federal deficit); and, as a result, we invest far less than our competitors in new plant and equipment needed for economic growth. We clearly are not going to be able to maintain our position as the world's leading economic power with such an inferior pattern of capital formation.

In the past, public policy has attempted to respond to our obvious shortfall in capital formation by creating tax incentives for new investment. While such an approach has been possible in the past, the various tax incentives enacted over the past several years have so reduced the significance of the corporate tax code that further "incentives" from this source may have only very small returns.

But low investment does continue to be a problem for the American economy. Therefore, we recommend the following steps to increase the rate of new business capital formation.

First, reduce the deficit. It is clear that, with our low household savings rate, high government deficits have a much more negative effect on business capital formation than would be the case if the savings rate were higher.

Second, implement a strong-growth monetary policy. Declining interest rates and revival of demand in both the U.S. and world economies would be a far more potent stimulus to new investment than any tax incentive. There is even some strong evidence that a rapid growth rate would in turn lead to a higher savings rate:

> A high growth rate is likely to feed back on a higher saving rate. This is because in a high growth economy the younger working and saving population will be more relatively wealthy to the retired dissavers than in a more slowly growing economy. So part of the reason we see a simple correlation, albeit far from perfect, between saving and growth rates is this causality from high growth to high saving with some life-cycle saving going on in the economy. It's a source of some controversy in economics as to how much saving behavior in the United States, or elsewhere, can be explained in this way, but I think the professional consensus is that at least a substantial fraction can be.—MICHAEL BOSKIN.

Third, pay attention to the "quality" of our capital investment. As we noted in the section of this Report dealing with debt, with the advent of financial deregulation, an increasing amount of capital has been going into speculative as opposed to productive investment. Debt-for-equity swaps, "leveraged buyouts," corporate mergers, and future trading all have a legitimate financial purpose, but all have been taken to extreme lengths in recent years, at the cost of productive investment in plant and equipment. We believe that moves to restrain many of these speculative practices are warranted, and note the Federal Reserve's recent imposition of margin requirements on shell companies being used in tender contests. We believe that far more attention needs to be devoted by both the Federal Reserve and the Securities and Exchange Commission to tip the balance back toward productive as opposed to speculative investment activity.

Fourth, support needed *public* investments in areas where private investment will generally tend to be inadequate. As we noted earlier in this Report, governments invest as well as spend, and we believe a key to improved competitiveness for the American economy is improved public investment in the areas of research and development, infrastructure, and human resource development.

Research and development

There is a clear and growing consensus that America is fast developing a serious problem with respect to research, particularly applied research, and that this problem will not correct itself without government action. Individual firms operating in a private market economy will tend to under-invest in research because it is often not possible for the firm to capture all of the economic returns of a given investment. With other competitors as potential "free riders" on any research investment, firms often prefer to spend their money on advertising or marketing, rather than research. The result is that American industry spends far less than does industry abroad on applied product or process research.

Not only is the rate of R&D higher in the civilian sector in other countries, but other governments provide far more support to commercially applied research than does our own. According to the National Science Foundation, West Germany devotes 14 percent of its government research budget to activities "promoting industrial growth." Japan spends 13 percent on the same function, France 8 percent, and England 4 percent. The United States, by contrast, devotes *only 1 percent* of its budget to such activity.

In response to this obvious problem of research and development, a broad range of actions have been recommended, but one recommendation stands at the top of virtually every list: fund at statutorily authorized levels the programs to expand industry-university cooperative research established by the Stevenson-Wydler Technology Innovation Act (P.L. 96-480). This has been recommended by the National Association of Manufacturers, the Business-Higher Education Forum, the Committee for Economic Development, the National Research Council, and the National Academy of Science. Despite this broad-based call for effective public research funding, the Administration has still not made a competitive research strategy part of its budgetary priorities.

We strongly recommend that this pattern of neglect be reversed. We believe that public funding for the development of new knowledge represents one of the best "investments" our government can make, and we also believe it is an investment which can only be made at an adequate level by government.

Other actions in the research area may be warranted. Because of the importance attached to this issue, the President's Commission on Industrial Competitiveness recommended the creation of a new cabinet-level Department of Science and Technology. The Commission felt that such an agency would both help shift the funding priorities of government toward this critical area, and facilitate a much-needed speedup in the transmission of new knowledge to the private sector.

Infrastructure

The ability to move people and goods quickly and to provide an adequate supply of clean water is essential for future economic growth and productivity. And that ability has been deteriorating at a rapid rate in recent years.

Between 1971 and 1981, spending by all levels of government on highways, bridges, mass transit, water, and sewer systems—the core infrastructure systems which keep the economy moving—fell from 1.5 percent of GNP to 0.78 percent. Measured in noninflated purchase power (1972) dollars, total infrastructure investment fell from $30 billion in 1965 to $25 billion in 1984, a 17 percent decline. On a per capita basis, such investment in constant dollars dropped from $236 per person in 1965 to $142 in 1984, a 40 percent decline.

The Transportation Systems Center of the U.S. Department of Transportation reports that, if the Nation's roads continue their present pace of decline, by 1995, deteriorated roads will cause an absolute reduction in the annual outputs of industries as diverse as pharmaceuticals, agriculture, and tourism. Econometric studies prepared by the Transportation Systems Center indicate that, if deterioration of the Nation's highways continues, the annual costs to the economy in 1995 will include the following: A 3.2 percent loss of gross national product; an 8.0 percent increase in the Consumer Price Index; a 5.9 percent decline in disposable income; a 2.2 percent decline in employment; and a 2.7 percent decline in labor productivity in manufacturing.

In 1982, the Joint Economic Committee commissioned an advisory panel, under the direction of its former Chairman, Henry Reuss, to study the condition of our infrastructure. The report of the commission estimated that, to meet tomorrow's demands, the United States must increase planned spending by $450 billion through the year 2000. It estimated that, to finance repair and reconstruction of highways and bridges, we will need $720 billion through the end of the century. Of that, only $455 billion will be available under existing programs, leaving a shorfall of $265 billion. For water supply and distribution, the spending gap is $41 billion; for wastewater collection and treatment, $49 billion; and for mass transit, $88 billion.

We believe that greater attention must be paid to rebuilding the productive infrastructure of our economy. This is predominantly a state and local responsibility, but the Federal Government can play an important role as catalyst in providing support for this form of needed public investment.

Human resources

While our physical infrastructure has been allowed to deteriorate in recent years, we have also not made an adequate national commitment to the development of our "human infrastructure." As we mentioned earlier in this Report, a skilled work force is our ultimate "comparative advantage" in international competition. But private firms and individuals have anatural tendency to underinvest in education and training. Therefore, one task of public policy is to facilitate the development of our human resources through increased funding and through innovations which make such funding more attractive to the private sector.

The Federal Government has a leadership role in assuring its citizens that education is both of high quality and assures each person an equal opportunity to compete in the economy. Education accounts for nearly 4 percent of the GNP, and the Federal Government can direct and nurture this investment in a number of ways. One possible method would be to support the School Effectiveness and Reform Act, which is a program to aid school districts in the use of their exisitng resources to optimum advantage. While this bill provides very little in the way of direct resources, it encourages the more effective use of existing resources at the school-building level and brings Federal education research findings down to the local level.

We have already noted the importance of improving the overall quality of our work force through improved education and more effective training and retraining. Other studies of the competitiveness program have recommended that increasing priority in Federal support be placed on improving scientific and technical education.

It is interesting to note that, in the decade of the man-on-the-moon effort, the United States thought that it was necessary to have programs for augmenting the supply of scientific manpower so that the demands of the space efforts did not cripple domestic industries. Yet, in the 1980's, with a much bigger buildup under way in the Defense Department, no similar efforts are being made to increase the supplies of scientific manpower.

In reality, there is a good chance that America will need a similar intensification of scientific effort in the 1980's, if it is to enjoy a competitive rate of growth. This intensification of effort is not going to occur automatically. Proposals in this area have taken a number of forms, all of which deserve serious attention: the President's Commission on Industrial Competitiveness recommended the establishment of 500 graduate fellowships and stipends in science and engineering; and the Business-Higher Education Forum recommended special loans to U.S. graduate engineering students who agree to teach, permitting the loan to be forgiven at a specified amount for each teaching year.

Another area of particular importance is improving mid-career training for American workers. In a dynamic economy, skills quickly become obsolete, and there is an urgent need for mechanisms to facilitate retraining of workers who are past normal school age. This includes both displaced workers and workers with secure employment who need additional training to improve their productivity.

In this area, greater attention needs to be given to proposals to strengthen mid-career training. One proposal deserving close attention is the recommendation of the Business-Higher Education Forum that Congress create an Individual Training Account similar to the Individual Retirement Account. But, because of the importance of encouraging training at all levels in the work force, if such a plan were to be enacted, it should involve some employer and government contribution—on a sliding-scale based on income—to the Individual Training Accounts of low-income workers. It would be inappropriate for Individual Training Accounts to tilt benefits toward the better-off, as is the case with today's Individual Retirement Accounts. In addition, efforts need to be made to move forward with the recommendation of the President's Commission on Industrial Competitiveness that tax policy strive to achieve a balanced tax treatment of business investments in both physical and human capital.

* * * * * * *

In summary, we believe that the challenge of international competition is real: it will not disappear with a simple decline in the value of the dollar and it is not solely the product of unfair trading practices abroad. But meeting that challenge will require an active partnership between the public and private sector, and aggressive new public policies to support improved competitiveness by American industry and to recognize the world as it is, not as we wish it to be.

ADDITIONAL VIEWS BY THE HONORABLE PARREN J. MITCHELL

I commend the Chairman of the Joint Economic Committee, David R. Obey, and the staff for preparing the 1986 Annual Report. The Report is instructive with respect to the difficult economic problems that we confront as a Nation. Appropriately, this year's Report contains a historical review, which focuses attention on the origin of many of our economic problems—unemployment, trade, productivity, and debt. A review of these trends indicates that none of the current conditions developed overnight, but instead are the consequence of policies that were ill-conceived. Thus, the purpose of my views is to address issues that have been ignored by this Administration and to build on the consensus among Democratic Members that is necessary if we are to develop practical solutions to our problems.

The conventional approach to developing fiscal and monetary policies that will achieve full employment and balanced growth has been obscured by the preoccupation of some with the Federal deficit. Ironically, this preoccupation comes at a time when it has been suggested that the deficit could fall without any action to reduce it. It is important that the deficit be reduced by decreased military spending and increased revenues. What is really essential is that we concentrate on developing economic policies that chart a predictable course into the future.

The Full Employment and Balanced Growth Act was enacted with the intention that Congress would develop economic policies to achieve specific goals. As indicated in the Report, the appropriate long-term goal for Federal fiscal policy must be full employment. Instead, what we have witnessed is the Federal Reserve Board's actions becoming the primary vehicle for developing policies that produce economic conditions that are tolerable. However, what is tolerable for financial markets is not tolerable for the economy as a whole.

One economic condition that is totally intolerable to me is black unemployment. Of course, my views are well known on this issue. But since 1978, the level of black unemployment has risen steadily and the policies put forth can be best described as inadequate. In 1960, three out of four black males were employed. By 1980, just one out of two black males was employed. During the past three years black unemployment has exceeded white unemployment by 9.9 percentage points. Black teenage unemployment is still in excess of 40 percent, 41.9 percent as of January 1986, compared to 14.9 percent for white teenagers. Similarly, black male adult unemployment of 12.7 percent is more than twice as high as white male adult unemployment, 5.0 percent.

The increase in unemployment among black males can be directly associated with the increase in the number of black female headed households and concommitantly with the increase in the number of black children living in poverty. What do we tell these children ten years from now? That the reason why there are few opportunities for you today is that we experienced huge Federal deficits in the past and therefore, we were not able to develop policies to assist your parents. No, that answer will not suffice. Moreover, the long-term costs of such an answer will be enormous.

The Administration's inability to address this problem is based on the notion that blacks and minorities are outside of the mainstream economy, unreachable by any policy measure. Alternatively, high black unemployment is the result of a changing economy and that strong economic growth is the best cure to reduce it. The signals, in my opinion, on this issue for the past five years represent a total failure in Federal policy.

It is clear that we need a national employment policy. The National Commission on Jobs and Small Business, of which I am one of the Congressional convenors, is developing policy alternatives to present to the Congress on how the Nation's small businesses can be utilized to create ten million permanent new jobs in the private sector. I strongly support the Commission and urge the Joint Economic Committee to play an active role in translating the Commission's policy alternatives into a national employment policy.

The Report focuses needed attention on inequality in income in the United States, in general. However, it does not treat the matter of inequality in income between black families and white families. Black families on average for the period between 1978 and 1985 earned 57 cents for every dollar of white family income. The lower income of black families translates into a lower standard of living when compared to white families.

Another issue of major importance to me is housing. I concur with the Report about the need for assistance to expand homeownership opportunities for first-time home buyers. Similarly, the housing needs of low-income renter households must be addressed. We have already witnessed a dramatic decrease in Federal spending on low-income housing programs and the most recent proposals of this administration would essentially eliminate most housing assistance programs. Yet, in the Presidents State of the Union Address, in pushing for spending cuts rather than a tax increase he said, "It's time we reduce the Federal budget and let the family budget alone." Indeed, the reductions in spending for low-income housing programs for families, who in many instances already spend more than half of their incomes for housing, will hurt family budgets, in a disproportionate way. True, there are many first-time homebuyers who can not afford to purchase a home, but there are still more families who can not afford decent rental housing.

I believe that the goal of maximum inflationary growth is an achievable objective of both fiscal and monetary policy. The attainment of this goal will require the coordination of the Administration, Congress and the Federal Reserve. In addition, the economic policies we develop must take into account the trade and international economic problems to be successful.

PARREN MITCHELL.

ADDITIONAL VIEWS OF THE HONORABLE AUGUSTUS F. HAWKINS

I commend Congressman Obey, the JEC staff and the other Members of the Committee for presenting a thorough and thoughtful Annual Report. Much of the analysis of the current state of the economy and the problems we are experiencing are right on target and make an excellent contribution to the current economic debate.

I am particularly supportive of the recommendation for monetary policy to be targeted to GNP growth, unemployment and interest rates, as it implements provisions of law, already enacted in the Full Employment and Balanced Growth Act. The Federal Reserve Board has consistently violated this mandate and the JEC's recommendation can go a long way to putting pressure on the Federal Reserve Board to begin to refocus its policy.

I also am very supportive of the call for more investment of resources in education, training, housing and other productive programs.

However, I must raise my objections to the continuing emphasis this committee puts on deficit reduction, as an over-riding goal of economic policy. This emphasis is misplaced and ignores the mandates of the Employment Act of 1946, who's 40th anniversary we celebrate this year, and the 1978 amendments of the Full Employment and Balanced Growth Act.

Deficit reduction should be the end result of pursuing a full employment and balanced growth program. It should not be the preeminent goal of economic decision-making.

The President's Economic Report fails to address this issue, and so, unfortunately, does this JEC annual report. The JEC's report should not only chastize current economic failings, but should take up the mantle and offer an alternative program which should have as its goal, bringing down unemployment to the legally mandated interim goal of 4%, within 5 years.

The JEC report should set short-term and medium-term goals not only for unemployment reduction, but also for production, real income, prices, and productivity. Goals are elements of the decision-making process, necessary so that we can measure and evaluate the progress we make.

Because the President's report fails to do so and merely forecasts what will happen in the next five years, it is no excuse for congressional abdication of its appropriate role in economic policy decision making.

I believe our committee loses an important opportunity to make a meaningful contribution to the coordination of economic policy by not offering a full employment and balanced growth alternative based on the achievement of specific goals and timetables.

We should be offering a fiscal, monetary and structural program based on full production and purchasing power. We should not shrink from our responsibilities, as mandated in law, to set quantatative economic goals, to be reached within given timetables, and to be focused upon the achievement of full employment for all those able and willing to work.

AUGUSTUS F. HAWKINS.

ADDITIONAL VIEWS OF SENATOR LLOYD BENTSEN

Chairman Obey, the Democratic Members, and staff are to be commended for the effort involved in preparing the recommendations and text for the 1986 Joint Economic Report. The report is provocative. And while I do not agree with all the recommendations contained in the Democratic views, I congratulate the Chairman for breaking new ground in a number of areas. These additional comments will more clearly state my own views.

ENERGY AND NATIONAL SECURITY

The Democratic Views to this Report correctly note that the decline in oil prices underway improves the near-term economic outlook. It is easy to overstate the beneficial effects of falling oil prices, however. Even so, Salomon Brothers and other respected analysts suggested they will add perhaps one-half a percentage point to real growth this calendar year. More significantly, it will dampen inflation and provide leeway for the Federal Reserve Board of Governors to pursue an expansionary monetary policy of the type recommended in the Democratic Views. That is good news.

The bad news is that falling oil prices dramatically jeopardize the economic health of energy producing regions of our nation. Indeed, Prudential-Bache analysts have found that $4 of every $5 of stimulus from falling oil prices is offset by their debilitating impact on the domestic energy industry. The contractionary economic effects were analyzed by economists at Southern Methodist University in Dallas. They found that if oil prices remain at $15 throughout 1986—and they may well average lower than that—my State of Texas will lose 250,000 jobs over the next three to five years. The loss of purchasing power will be a staggering $30 billion. The heart of the energy production industry is drilling. That segment has been weakening for the last several years as oil prices declined in real dollars. But since January, drilling has plunged. All together, some 33,000 jobs in the drilling industry have been lost since its 1981 peak. And the unemployment rolls grows daily. The oil service, rig fabrication, ship repair, and steel industries in the oil patch are in the midst of a deep recession, as well. And this comes atop two severe years when both agriculture and the petrochemical industry have been staggered by the bloated dollar in Texas and across the nation.

Nationally, these industries remain our nation's leading trade sectors, with exports far outrunning imports. Yet, their ability to compete in world markets has been dramatically hobbled by the fiscal and trade policies of the Administration. Those policies have fallen heavily across the spectrum of this nation's manufacturing base. No area or industry has escaped the impact of high dollar interest rates, mercantilist trade policies abroad or the sky-high dollar. In Texas, 118,000 manufacturing jobs on a net basis have been lost since 1981. Nationally, the jobless run into the millions. It is little wonder that a good portion of the Democratic Views in the Report are devoted to a discussion of the competitiveness challenges facing our nation.

But an equally threatening challenge for the United States is the threat posed by excessive reliance on foreign energy. By dint of considerable investment in energy conservation and oil exploration, we reduced our dependence on import oil to 31 percent last year from a high 47 percent in 1977. Moreover, our oil reserves have actually increased over the last three years in the face of rising domestic production. Those gains were hard won. And they were won because reducing energy dependence was a national priority in the Seventies.

The Administration does not view energy security as a national priority. It has rejected proposals to stablize domestic production with, for example, oil import fees. This absence of an energy policy has had dramatic results. Oil exploration has ground to halt. Accordingly to the weekly count by the Hughes Tool Company, drilling activity has plunged by one-third in barely two months to a 14-year low. Exploration budgets are being truncated. Texaco, Inc. will cut its capital budget this year by at least 11 percent. Conoco, Inc. has reduced its exploration and production budget by $300 million. Cuts of 20 percent or more have been announced by Phillips Petroleum Company, Amoco Corporation, Atlantic Richfield Company, and Unocal Corporation.

Production is declining, as well. Sliding prices are falling below variable costs for many producers, especially owners of higher cost North Slope and small stripper wells. Phillips Petroleum has closed 35 wells already in Texas. Crude production is down 30,000 barrels a day in the last three weeks alone. And that is the merest tip of the iceburg. Recent testimony before the Senate Finance Committee revealed that stripper well output will decline by one million barrels this year if prices remain low. Alaskan North Slope production was already scheduled to peak next year. With prices at current levels, the decline in output will be dramatic. As a result of stripper well closures alone, foreign imports will surge to nearly 40 percent of our domestic oil consumption by year's end.

Moreover, the demand for oil is rising. A study by Georgetown University's Center for Strategic and International Studies found that oil demand will rise quite quickly as prices ebb to $10 per barrel. Cheaper oil is already backing out natural gas and coal. And the CSIS analysis found that demand could jump as much as 1.5 million barrels per day in the next several years. Indeed, Deputy Energy Secretary Boggs testified that foreign oil imports will supply one-half of all domestic supplies by 1990 or 1991 at current prices. And, given the long lead time for exploration to yield proved reserves, domestic production will decline even more dramatically after 1991. Our import dependence will continue rising, exposing our economy to even higher risks of manipulation by foreign oil suppliers.

Our additional barrels of imported oil will come from OPEC. Non-OPEC oil sources are already running wide open. China, Canada, the North Sea, Mexico, even Russia—are tapped out. This lack of spare capacity is compounded by the peaking of non-OPEC suppliers. Canada peaked last year. Australia peaked in 1984. Great Britain will peak this year; even frugal Norway's production will peak in 1989. Administration refusal to adopt an energy policy designed to minimize OPEC oil imports threatens our national economic and security interests.

FISCAL AND MONETARY POLICY

The Democratic Views correctly point out that monetary policy should bear the major burden of supporting continuation of the recovery. I am not convinced, however, that the risk of inflation has diminished to the point where the Federal Reserve should abandon the use of monetary targets. It should not move away from them. Rather, it should strike a balance in its policy deliberations, making use of real GNP as well as monetary aggregate targets.

The most pronounced fiscal policy challenge we face remains deficit reduction. Those reductions should come from reduced spending. And I believe spending cuts can achieve a balanced budget if interest rates continue subsiding. Tax increases designed to reduce the deficit are a last resort.

Moreover, I am not yet convinced that entitlement reductions are necessary to achieve balanced Federal budgets. For these reasons I am not in agreement with the tax and fiscal policy recommendations in the Demcrotic Views, although I certainly will seek passage of my legislation tightening minimum tax requirements. In that regard, exploration of questions regarding the size of the full employment, actual or normal deficits are important. But that academic exercise should not obscure the need to balance the Federal Government's receipts and outlays promptly. All our belts must be tightened. And the focus should be on streamling Federal programs, not increased spending.

OTHER ECONOMIC ISSUES

The Democratic Views touched on a variety of other topics. Far too little examination has occurred of the so-called junk bonds phenomena. And I withhold judgment on their utility, and of the Federal Reserve's related decision until more information becomes available. The Democratic Views note the recent sluggish investment and productivity performance of our economy, and suggest that investment incentives are not the most essential ingredient in promoting productivity. There are certainly many other factors which bear on the pace of investment. Yet there is overwhelming evidence that investment incentives are a key component of investment decisions and of investment levels. Incentives are the most essential factor in a great many instances. For that reason, the dramatic reduction in investment incentives in the House-passed tax revision legislation (H.R. 3838) will exacerbate our weak investment and productivity performance. We need to define and focus such incentives more carefully, as well as promote cooperative labor management relations. Both the capital and labor sides of the productivity equation need attention. Some of the many labor-management issues bearing on productivity are poorly understood. And, factors such as employee ownership, job flexibility, employment security, worker involvement in management decisions, work sharing, and gain sharing warrant more careful study before being endorsed as solutions to lagging productivity.

The Democratic Views discuss the distribution of income and economic equity. They urge a reform of this nation's commitment to college aid, unemployment compensation, income maintenance, worker training, and housing, especially housing for young families. In light of the deep budget deficit, these reforms should not be achieved through additional spending. And I do not fully endorse them until further intensive evaluation of these possible reforms has occurred. Similarly, regarding recommendations for additional Federal spending on R&D, infrastructure, and human resource development, our focus should be on raising their effectiveness, not their level of outlays.

THE INTERNATIONAL ECONOMY

As the Democratic Views correctly note, we need to move beyond *ad hoc* Central Bank intervention for exchange rate control to the establishment of a new system in which the impact of speculative capital flows is minimized. The Treasury Secretary should certainly examine new options, including target zones and macroeconomic policy coordination between nations. He should examine proposals to prevent U.S. wage deterioration due to trade, and to ease the third-world debt crisis, as well. Any options he develops should then be presented to Congress. The third world debt crisis is a particularly pressing issue. The Administration is correct in seeking to promote greater growth and reliance on the free market in debtor nations. If faster growth in these nations can be channeled internally, it will promote U.S. exports and growth, as well.

LLOYD BENTSEN.

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REPUBLICAN VIEWS ON THE FEBRUARY 1986 ECONOMIC REPORT OF THE PRESIDENT

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I. ECONOMIC POLICIES TO STRENGTHEN, LENGTHEN, AND BROADEN THE ECONOMIC EXPANSION

INTRODUCTION

Few economists would stake their reputation on a forecast that there will not be recession between now and 1991. Of course, few economists forecasted the length of the current recovery. It's often argued that the business cycle will catch up to us and that expansion will eventually give way to recession.

Is the right recession avoidable? The answer is yes. This part of the annual report by Republican Members of the Joint Economic Committee indentifies several policy actions which would not only lengthen the current economic expansion but also strengthen and broaden it.

The Administration's forecast of 3.4 percent real GNP growth (year over year) for 1986 is quite reasonable, and even faster growth is within the realm of possiblity. Several favorable factors portend a significant increase in growth from 1985's 2.3 percent advance:

The outlook for consumer spending is optimistic, owing to favorable situations in consumer assets and debt.

The decline in oil prices will keep inflation lower than it otherwise would be and will provide some mild stimulation to the economy, particularly in the energy-using sectors.

The dollars depreciated by about 20 percent during the past year, and this will help net exports in 1987.

Business inventories have dropped to a level at which inventory rebuilding can be expected during 1987.

Higher stock market prices are a positive leading economic indicator. More directly, they add to consumers' assets and bolster the ability of corporations to raise funds for investment.

The Federal Reserve appears likely to continue with expansive monetary policy. Monetary growth during the past months provides a base for economic growth this year.

The outlook is not without risks. Imports keep flooding in, and we cannot yet determine the likely magnitude of benefits from the lower dollar. Agricultrural exports in particular have shown little response. Business investment also has shown some signs of faltering.

Some forecasters are concerned about the effects of reducing Federal spending as part of an effort to balance the budget. We ae not worried about this, as we explained in detail in our report *Toward an Economy Without Deficits* (January 10, 1986). We believe that restoring fiscal balance will be of great long-run benefit to the economy because it will reduce the role of Federal borrowing in capital markets, both foreign and domestic. Effective demand released by lower interest rates and by higher stock prices will more than offset reduced Federal spending, assuming that a reasonably noncontractionary monetary policy is pursued. However, we continue to caution that attempting to balance the budget by raising taxes would have serious negative effects on the economy.

II. THE LONG TASK OF DEFICIT REDUCTION

The Federal Government enters the fiscal 1987 budget cycle after the most significant amendment of the Budget Act since it became law in 1974. The Gramm-Rudman-Hollings deficit reduction (GRH) amendment to the recent debt limit extension commits Congress to a schedule of dificit reduction over the next five years: baseline deficits must decline to $144 billion in 1987 and by $36 billion each fiscal year. By 1991 the deficit would be totally eliminated. Complying with the law will not be easy for the Congress, but as pointed out in our yearend report, elimination of the budget deficit by spending restraint would considerably improve the economic outlook.

FAILURE OF THE BUDGET PROCESS

The widely acknowledged failure to control the growth of Federal spending has created a mood of deep frustration in recent years, leading to the passage of GRH last December. The spectacle of last year's 1986 budget resolution mandating a $55 billion in deficit reductions and a deficit of $172 billion, followed by allegations of inflated savings and then a projected 1986 deficit of $220 billion, proved to be the last straw. The 1986 resolution was regarded as a charade even by then prevailing standards. The results of congressional inability to control Federal spending can be seen in the historical record of budget trends.

A review of the facts shows that since 1965 Federal spending has expanded briskly, both in nominal and real terms, and as a share of GNP, since 1965. Between fiscal 1965 and fiscal 1985, outlays increased 700 percent, from $118 billion to $946 billion. Even in real terms, 1985 Federal outlays were 214 percent of their 1965 level. This 4 percent annual real growth rate outpaced that of the economy, thereby pushing the Federal outlay share of GNP from 17.6 percent to 24 percent. Had this share of GNP remained at its 1965 level, the amount of outlays would have been $253 billion less than in 1985, resulting in a $41 billion budget surplus in that year, given 1985 revenues.

Meanwhile, Federal revenues rose from $116.8 billion in 1965 to $734 billion in 1985. The share of GNP claimed by Federal receipts increased from 17.3 percent in 1965 to 18.6 percent in 1985. The 1985 revenue share of GNP is virtually identical to that of the postwar average, which includes the high tax years of the late 1970's and 1980–81. In 1981, the revenue share of GNP amounted to 20.1 percent, equal to its highest level since 1945. By starting with this aberrant base year, opponents of the 1981 tax cut have blamed it for the deficit problem. This assumes as normal the revenue level-produced by inflation-induced tax increases and the resulting bracket creep. However, this revenue level was as much a result of policy as was the post-1981 revenue level.

In the first instance, the policy was to permit accelerating inflation to increase the tax burden to a peacetime high. This policy, if continued into the 1980's, would have indeed extracted many hundreds of billions of dollars more from American taxpayers. On the other hand, the policy implemented in 1981 sought to repeal the surreptitious tax increase of the previous years, bringing revenues back in line with historical experience. Advocates of the unlegislated tax increases of the 1970's then opposed, and still oppose, the Administration's policy. The Republican Members of the Joint Economic Committee commend the 1981 tax bill for restoring incentives to work, save, and invest, thereby contributing to one of the strongest economic expansions in the 20th century. We are proud of the JEC's development of this strategy under bipartisan leadership in 1979–80.

The revenue share of GNP, currently at 18.6 percent, is within 0.3 percent of the 1979 level of 18.9 percent, even after the supposedly massive tax cuts that allegedly "starved" the Treasury. The notion that the 1981 tax cut caused the huge budget deficits is a myth. The Federal outlay share of GNP in 1985 was 24 percent, about 5 percentage points over the average level during 1946–80. The difference between the GNP share of revenues, which is at the historical average, and outlays, which are not, results in a deficit share of GNP of 5.4 percent. Clearly, it is spending growth, not revenues, which has increased the deficits over the last five years.

The table below shows how Federal spending growth has continued to outpace the growth of Federal revenues. Over the last two decades, Federal outlays have expanded to comprise almost one quarter of national output. The inability to contain this spending growth is the main reason for congressional support of institutional reforms such as GRH and the Balanced Budget Consitutional Amendment.

TABLE II.1.—OUTLAYS, RECEIPTS, AND DEFICITS, 1965–85

[Dollar amounts in billions]

Year	Outlays		Receipts		Deficits	
	Amount	Percent of GNP	Amount	Percent of GNP	Amount	Percent of GNP
1965	$118.2	17.6	$116.8	17.3	$1.4	−0.2
1970	195.6	19.8	192.8	19.5	−2.8	−.3
1975	332.3	21.8	279.1	18.3	−53.2	−3.5
1980	590.9	22.2	517.1	19.4	−73.8	−2.8
1985	946.3	24.0	734.1	18.6	−212.2	−5.4

Source: Office of Management and Budget

COMPOSITION OF BUDGET OUTLAYS

The changing composition of the budget helps explain the explosion in Federal spending over the last 20 years. The dramatic shifting of budget priorities between two budget categories—transfers and defense—and the rapid real growth rate of the former, is by far the most important development in budget policy.

In 1965 transfer payments amounted to $33 billion, 28 percent of total outlays, and 4.9 percent of GNP. By 1985 transfer payments had jumped by 1190 percent to a level of $425.6 billion, accounting for 45 percent of total outlays and 10.8 percent of national output. In real terms 1985 transfer payments amounted to 409 percent of their 1965 levels, posting an annual real rate of growth of 7.3 percent.

This expansion of transfers was financed by shifting funds from defense and later by allowing inflation to impose unlegislated tax increases. Defense outlays in 1965 were $50.6 billion, accounting for 42.8 percent of Federal spending and 7.5 percent of national output. 1985 defense outlays, at $252.7 billion, were 500 percent of their 1965 level in nominal terms, but their share of total outlays had fallen to 26.7 percent, and their GNP share to 6.4 percent. Although the Administration's policies have reversed the trend that culminated in the 1980 defense budget falling to at 23.2 percent share of total outlays and 5 percent of GNP, it remains far below the levels of the 1960's, even before the Vietnam War. Real defense outlays in 1985 were 24.8 percent above their 1965 level, and this is about one-twelfth the real increase in transfer program. In constant 1982 dollars, the average annual rate of growth in defense expenditures was 1.1 percent.

The table below displays the ballooning of transfer payments relative to defense as a share of the budget and output. It also shows the growth of the net interest function as debt servicing costs have increased with the climbing national debt, and the higher borrowing costs after 1980.

TABLE II.2.—COMPOSITION OF FEDERAL OUTLAYS, AND FEDERAL OUTLAYS AS A PERCENT OF GNP (1965–85)

Federal outlays	1965		1970		1975		1980		1981		1982		1983		1984		1985	
	Percent of GNP	Percent of outlays	Percent of GNP	Percent of outlays	Percent of GNP	Percent of outlays	Percent of GNP	Percent of outlays	Percent of GNP	Percent of outlays	Percent of GNP	Percent of outlays	Percent of GNP	Percent of outlays	Percent of GNP	Percent of outlays	Percent of GNP	Percent of outlays
Total outlays	17.6	100.0	19.8	100.0	21.8	100.0	22.2	100.0	22.7	100.0	23.7	100.0	24.3	100.0	23.1	100.0	24.0	100.0
On budget	15.1	86.0	17.0	85.9	17.8	81.8	17.9	80.7	18.2	80.1	18.9	79.7	19.9	81.8	18.6	80.5	19.5	81.3
Off budget	2.5	14.0	2.8	14.1	4.0	18.2	4.3	19.3	4.5	19.9	4.8	20.3	4.4	18.2	4.5	19.5	4.5	18.7
National defense	7.5	42.8	8.2	41.8	5.7	26.0	5.0	22.7	5.3	23.2	5.9	24.9	6.3	26.0	6.2	26.7	6.4	26.7
Nondefense:																		
Payments for individuals	4.9	28.0	6.5	33.1	10.1	46.2	10.4	47.0	10.8	47.7	11.4	47.9	11.9	48.9	10.8	46.9	10.8	45.0
Direct payments	4.4	24.9	5.7	28.7	9.0	41.2	9.2	41.6	9.6	42.2	10.1	42.8	10.7	43.8	9.6	41.7	9.6	39.9
Grants to State and local governments	.5	3.1	.9	4.4	1.1	4.9	1.2	5.4	1.2	5.4	1.2	5.1	1.3	5.2	1.2	5.2	1.2	5.1
All other grants to State and local governments	1.1	6.1	1.6	7.9	2.2	10.0	2.2	10.1	1.9	8.5	1.6	6.7	1.5	6.3	1.4	6.2	1.5	6.1
Net interest	1.3	7.3	1.5	7.4	1.5	7.0	2.0	8.9	2.3	10.1	2.7	11.4	2.7	11.1	3.0	13.0	3.3	13.7
All other	3.7	20.9	2.8	14.4	3.2	14.9	3.3	14.8	3.3	14.6	3.0	12.7	2.9	11.9	2.5	10.8	2.9	12.0
Undistributed offsetting receipts	−.9	−5.0	−.9	−4.4	−.9	−4.1	−.7	−3.4	−.9	−4.1	−.8	−3.5	−1.0	−4.2	−.9	−3.8	−.8	−3.5
Total nondefense	10.0	57.2	11.5	58.2	16.1	74.0	17.1	77.3	17.4	76.8	17.8	75.1	18.0	74.0	16.9	73.3	17.6	73.3

BENEFITS OF FEDERAL SPENDING RESTRAINTS

The resources devoted to funding any Federal expenditure must be extracted from the private sector by taxation, borrowing, and/or printing money. All three means of financing government cause crowding out by removing resources from the private sector where they were generated, and diverting their use to the government.

In some cases, the benefits to each member of the community exceed the tax imposed on each to finance the provision of a public good. If at least one person is made better off, and no one worse off, then a case can be made for the expenditure. On the other hand, many Federal expenditures are undertaken for essentially political reasons with little or no economic benefit. At the margin, these extractions of resources cost the private economy more than they are worth.

Not only are resources diverted from private uses, but additional costs are generated as well. For example, the economic cost imposed by the level of current marginal tax rates is a very significant burden that may even exceed the tax revenues generated. This cost takes the form of tax compliance expenses and disincentives to work, save, and invest. It should go without saying that unless Federal program benefits exceed their total costs, the expenditure should not be made. When indirect costs are considered, many Federal programs fail this test.

The abandonment of fiscal restraint in the "Great Society" decade of the 1960's led to the enactment and dramatic expansion of domestic programs, without adequate consideration of potential future costs. This resulted in the expansion of such programs well beyond anything their proponents or anyone else had thought possible or desirable. The relaxation of fiscal discipline affected other elements of domestic spending as well.

One aspect of the Great Society deserves special attention. Through scholarly books, articles, and extensive hearings before the Joint Economic Committee, it is becoming increasingly clear that American welfare policy has not achieved its objectives. There is increasingly persuasive evidence that the major welfare programs distort incentives and encourage behavior and conditions which undermine the nuclear family and the transmission of social values, work effort, and education, thereby promoting a new cycle of welfare dependency. A comprehensive restructing of the whole array of welfare programs is urgently needed.

THE IMPROVING BUDGET OUTLOOK

The baseline budget projections assume a special importance this year as they are the base from which the GRH sequester orders are calculated. Only a few weeks ago, semi-official estimates projected a fiscal 1987 deficit of about $200 billion. Under GRH, a $56 billion reduction in the deficit would have been needed to meet the fiscal 1987 deficit target of $144 billion. This strengthened the argument of those who asserted that a politically acceptable resolution would require a significant tax increase.

However, with the release of new OMB and CBO baselines, the current deficit outlook is much brighter. OMB estimates the fiscal 1987 current services deficit at $182 billion, and CBO at $181 billion. This would lower the magnitude of the maximum sequester order to about $38 billion, if Congress failed to reduce the deficit below the $154 billion which includes the $10 billion cushion.

Furthermore, economic conditions seem to be improving significantly. Among the postive economic indicators, the very strong rise of 565,000 in payroll employment in January, is especially encouraging. The collapse of oil prices is clearly positive for the budget outlook. Not only will improved economic growth expand the tax base and lower safety net spending, but lower inflation could save billions of budget dollars directly and indirectly. Lower inflation will tend to restrain labor costs, interest payments, COLA adjustments, and other expenses, while fuel purchases in the energy-intensive defense budget will be directly affected by lower oil prices.

The long-term outlook is also favorable, though subject to more forecast error. Both budget agencies project falling deficits through 1991 on a current services basis, assuming the March 1 GRH sequester order goes into effect. This order will trim budget authority not just in fiscal 1986, but in future years as well. If Congress does nothing, both forecasts show the 1991 baseline deficit at $104 billion. The CBO baseline is displayed below.

TABLE II.3.—CBO BASELINE BUDGET PROJECTIONS

[By fiscal year]

	1986	1987	1988	1989	1990	1991
	In billions of dollars					
National defense	269.5	284.0	296.4	310.9	326.9	343.9
Entitlements and other mandatory spending	453.7	473.6	509.0	536.4	566.5	604.1
Nondefense discretionary spending	173.2	174.3	182.6	188.3	195.9	204.0
Net interest	138.6	145.0	154.4	157.6	159.1	160.3
Offsetting receipts	−48.8	−51.5	−56.4	−58.4	−60.7	−64.4
Total outlays	986.1	1,025.3	1,085.9	1,134.9	1,187.6	1,247.9
Revenues	777.8	844.0	921.0	991.3	1,067.5	1,143.6
Total deficit	208.3	181.3	164.9	143.6	120.1	104.3
Debt held by the public	1,720.1	1,900.4	2,064.4	2,206.9	2,326.1	2,429.4
	As a percent of GNP					
National defense	6.4	6.3	6.1	6.0	5.8	5.7
Entitlements and other mandatory spending	10.8	10.5	10.5	10.3	10.1	10.0
Nondefense discretionary spending	4.1	3.9	3.8	3.6	3.5	3.4
Net interest	3.3	3.2	3.2	3.0	2.8	2.7
Offsetting receipts	−1.2	−1.1	−1.2	−1.1	−1.1	−1.1
Total outlays	23.5	22.8	22.4	21.8	21.1	20.6
Revenues	18.6	18.7	19.0	19.0	19.0	18.9
Total deficit	5.0	4.0	3.4	2.8	2.1	1.7
Debt held by the public	41.0	42.2	42.7	42.3	41.4	40.2
Memorandum: GNP	4,192.0	4,504.0	4,838.0	5,214.0	5,619.0	6,047.0

Source: Congressional Budget Office.

According to these new baseline forecasts, an explosion of net interest costs, of growing concern just a few months ago, is not in sight through 1991. According to CBO, net interest will amount to $145 billion in 1987, then climb to $154 billion in 1988. After 1987, these costs will slowly creep upward to a level of $160 billion by 1991.

A quick review of the baseline numbers illustrates the reason for the better budget outlook. Previous baseline forecasts have generally projected outlays rising by an annual average of $92 billion annually, outpacing by $18 billion the average $74 billion rise in revenues. The cumulative effect of this trend was, of course, larger budget deficits.

According to the current baseline, annual revenue growth would average $73.4 billion through 1991, in keeping with past projections. Average outlay growth, however, has been reduced from $92 billion to $53 billion annually. The cumulative effect of the lower growth path of spending is to reduce projected 1991 outlays by almost $200 billion, causing a swing in the deficit from the $300 billion range to a little over $100 billion.

The $104 billion 1991 deficit forecasts assumes that the March 1986 sequester order is implemented, but that no further cuts are made. In other words, if Congress does nothing except adhere to the baseline, the deficit would fall to this level, which would be 1.7 percent of estimated GNP. This baseline illustrates the dramatic effects that lowering Federal spending growth would have on the budget deficit in the out-years.

Several caveats are in order. The CBO baseline does not assume a severe recession in the next five years, and such an event would naturally change the baseline for the worse. Furthermore, CBO assumes zero real growth in defense budget authority, which may or may not be realized in future congressional actions. Lest we be accused of over-optimism and complacency, we are not suggesting that the magnitude of the budget problem will melt away without strong congressional action. The baseline does, however, lead to certain conclusions about how best to address the budget situation.

Assuming the reasonableness of the CBO's economic assumptions, the task before Congress is to trim Federal spending growth enough to eliminate the $104 billion 1991 deficit. In the next five years, Congress must cut budget authority and outlays enough to reduce 1991 baseline outlays by $110–120 billion, in order to come within close range of the target, allowing for a margin of error. Because of the reduced baseline, annual reductions in outlays averaging at most $20 billion would likely be sufficient to meet the targets in each year after 1987.

Deficit-cutting actions taken during fiscal 1987 would reduce baseline deficits in the outyears as well. With each subsequent budget cycle, the growth path of budget authority would be ratcheted downward further as Congress complied with the budget law. By fiscal 1989, the baseline deficit would be less than 2.3 percent of GNP.

Considering the hysteria that GRH has generated among special interest groups, this goal is relatively modest. Less than 3.0 percent of fiscal 1987 outlays need be trimmed from the baseline to comply with the law. If Congress were to legislate reductions amounting to $27 billion, the projected deficit would fall to $154 billion. The $10 billion cushion built into the law gives the Congress some flexibility.

Even if the CBO defense numbers were boosted another $10 billion by Congress, the $34–44 billion outlay savings needed would be hardly Draconian. The target can be met by restraining spending growth.

Although GRH provides for no tax increases, some proponents of the legislation, at the time, contended it would force the President to accept a tax increase. A tax increase is but an excuse to shield constituent programs from any real exercise of fiscal responsibility. A tax increase is simply not needed to reduce the budget deficit. Instead, low priority programs and expenditures should be sharply curtailed. These activities should be funded by program beneficiaries or by other interested parties.

INSTITUTIONAL REFORM OF THE BUDGET PROCESS

No instrument of policy can compensate for the inability of Congress to reach agreement on policy to deal with runaway Federal spending and deficits. The pre-GRH budget process has totally failed to restrain Federal spending growth. In addition, the budget-cycle timetable and other procedural aspects of the Budget Act are routinely ignored or circumvented. Only one element of the Act—reconciliation—has proved capable of effecting needed budget changes, and this in a way that was never intended by the authors of the Act. Even the innovative use of reconciliation as an instrument of budget control, for all its earlier successes in the early 1980's, cannot remedy the basic institutional problems. Under current conditions there is an inherent spending bias in the legislative branch. Reconciliation is most effective as an instrument when a consensus can be reached on a policy of fiscal restraint. However, under existing ground rules there is little likelihood that such a consensus can be achieved, given the magnitude of the problem at hand.

The Balanced Budget/Tax Limitation Constitutional Amendment could address this problem by requiring a balanced budget in all but extraordinary circumstances. Section 1 of the Amendment requires Congress to adopt a balanced budget plan prior to each fiscal year. Congress could waive this requirement by a three-fifths vote in each chamber. Otherwise, under this section, actual outlays would not be permitted to exceed planned outlays. However, a deficit from a revenue shortfall resulting from a recession would be tolerated. Section 2 states that the rate of planned revenue growth may not exceed the growth rate of national income, unless a majority of *all* Members of both Houses of Congress pass a bill that has become law. Since the level of Federal receipts and spending normally must balance, Section 1 also indirectly places a limit on the growth rate of Federal outlays. Moreover, there is an escape clause in the event of war.

In addition, Congress should consider granting a line-item veto authority to the President to be exercised on appropriation bills, perhaps on a temporary or limited trial basis, as suggested by Senator Mattingly in S.43, legislation he has introduced. The experience of the chief executives in the 43 states that possess this spending control authority indicates that it could prove to be a significant asset in the effort to reduce Federal spending.

Other reforms in the fiscal process are potential money-savers. For example, indexing Treasury securities is one proposal that bears examination as a means of reducing the cost of government borrowing.

III. STRENGTHENING THE EXPANSION

Growth in gross national product slowed in 1985. Economic growth is always desirable, but during the next several years it is vital. Without sufficient growth, eliminating the budget deficit will be impossible.

In this chapter we discuss policies to strengthen the expansion. We believe that the following actions are necessary:

Get Federal spending and the deficit under control, as discussed in Chapter II.

Maintain the current balance in monetary policy, which so far has supported the expansion, lowered interest rates, and avoided inflation.

Aim for long-term stability in these and other Federal economic policies.

MONETARY POLICY

The trend in monetary policy during 1985 seems to have been expansionary, and this is a good omen for 1986 and beyond. The monetary base increased 9 percent during 1985. The M-1 money supply (currency plus demand deposits), which is designed to measure the public's transactions balances—however imperfectly—increased at approximately 12 percent. Other indicators of an expansionary tilt to monetary policy are the pronounced decline in both exchange rates and interest rates throughout 1985, and the gentle rise in indexes of spot commodity prices during the fourth quarter.

Although monetary policy seems to have been expansionary, there are several issues that puzzle economists. These important, unanswered questions make it difficult, if not impossible, to evaluate whether the monetary stimulus at the beginning of 1986 is just adequate to sustain and strengthen the expansion, or whether it is insufficient or too great.

Those who might argue that monetary stimulus in the economy is insufficient would point to the forecasts by various private sector economists that in 1986 real growth is likely to be in the region of 3 percent. There is little doubt that further lowering of interest rates and a more rapid expansion of the monetary base would increase real growth in 1986. But those who worry about the risk of inflation see the strong growth in M-1 and the monetary base during 1985 as fueling a growing economy with such an initial pool of funds that 1986 will see a rapid acceleration from 1985 growth rates and propel the economy to levels beyond the rate of sustainable real growth in 1987. It is of some concern that monetary expansion in 1976-80, which led to the highest inflation and interest rates in U.S. history, averaged about 8 percent, well below today's levels.

Yet there are problems in simply comparing the monetary policy indicators of the past with today's rates and attempting to infer consequences. For example, the ratio of gross national product to

M-1, the velocity of money, has begun to move well below its long-established trend, which would suggest that now, more than in previous decades, sustained non-inflationary growth is consistent with larger increases in the money supply. Yet, even this conclusion is not necessarily correct because, as shown in a research paper by William S. Haraf of the American Enterprise Institute, monetary velocity behaves statistically as a non-stationary process—like a "random walk"—in which previous steps are useless in predicting those that follow. Moreover, the monetary velocity statistics are not even as reliable as a random walk, which is the simplest model of a non-trend stationary process. While velocity seems to behave like a sloppy random walk, the implications for monetary policy are serious: At any point in time, the Federal Reserve cannot know the optimal money supply strategy for non-inflationary economic growth.

Economists today, following the experience of 1981-83, are more aware that monetary policy will have a larger impact on employment and the pace of overall economic activity than government spending. Unfortunately, however, without a reliable theory of the relationship between any active policy and the consequences of the action, the Federal Reserve cannot safely alter its monetary policy except when there are clear signs of failure. Without risks of overcompensating, it can neither encourage faster economic growth nor restrain the early signs of inflation. Velocity may be greater or less next quarter or next year, so an increase, or slowing, in the money supply may be unpredictably magnified or nullified.

It used to be a tenet of monetarist theory that velocity is relatively stable, and the tactic of holding the growth rate of M-1 steady would be a stabilizing rule for monetary policy. Research on monetary velocity has been used to attack the monetarist argument. While it is a serious challenge, it is not at the same time an argument for relying upon the discretionary wisdom of the Federal Reserve to decide how the money supply should fluctuate from quarter to quarter.

With the old quantitative relationships between M-1 and inflation apparently changing, it is tempting to look to other targets as an alternative, e.g., interest rates, commodity prices, nominal GNP, etc. In the past five years, real interest rates have moved to heights not seen since the 1920's. While several factors have been cited as responsible for high real interest rates, including the Federal budget deficit, research by Professors John Huizinga of the University of Chicago and Frederick Mishkin of Columbia University points to Federal Reserve policy as the principal determinant of the current level of real interest rates. There is no doubt that real interest rates shifted from low and even negative levels in the 1960's and 1970's to high positive levels in the 1980's.

Federal Reserve operating procedures are the central tools of monetary policy, irrespective of the details of growth rate targets or interest rate targets. If the Federal Reserve's operating procedures cause high real interest rates, it is worth considering modifications in those procedures that would permanently establish lower real interest rates, perhaps at levels consistent with the experience of the 1950's. This line of argument would suggest that it is within the power of the Federal Reserve to cut its discount rate and drop market interest rates across the spectrum by 1 to 3 percent—to levels that were common during the 1950's.

The Federal Reserve's operating procedures are essentially the same today as in the 1950's. Borrowings by banks from the Federal Reserve at the discount rate and non-borrowed reserves that are created through open market operations are watched closely. The Fed decides whether the relative proportions are consistent with its current monetary policies. In addition, the interest rate differential between the fixed discount rate and the more competitively determined Federal funds rate is watched. (This spread is usually labeled "tight" or "loose" depending upon whether it is allowed to increase without the Fed supplying funds or to decrease without the Fed absorbing funds from the banking system.) Moreover, the Federal Reserve district banks follow somewhat independent policies in regard to discount lending, which can result in erratic and larger-than-expected shifts in the monetary base.

While a further reduction in interest rates at the present time would clearly be desirable, it is not at all clear that the overall impact of a cut in the discount rate would be beneficial for current monetary policy. It would not be appropriate for the Congress or the Administration to pressure the Federal Reserve into any action that would create further uncertainty or instability for the sake of temporary economic gains.

As a policy recognizing the potential damage from trying to "fine tune" the economy through capital market intervention, the Federal Reserve's strategy for the past eight months was quite reasonable. The Fed added reserves to the banking system whenever the Federal funds rate reached 8 percent and drained reserves whenever the Federal funds rate reached 7.75 percent. A continuation of this "smoothing" policy for the balance of 1986, without significant change, may prove to be the best strategy for economic growth. Such a policy is procyclical, but at the present stage of the growth cycle, with 1985 relatively weak and 1986 looking more favorable, a procyclical monetary policy will merely strengthen the expansion.

TAX INCREASE UNNECESSARY

The budget section in Chapter II reviewed the baseline outlay and revenue trends through 1991. It was shown that the Gramm-Rudman-Hollings (GRH) deficit targets could be met without a tax increase. Moreover, a tax increase is exactly the wrong response in the current situation. First of all, a tax increase would lessen pressures on Congress to cut low priority programs that are less valuable than the private activities that a tax increase would crowd out. The amount of private resources absorbed by the Federal Government would be unchanged under a tax increase since the sale of Treasury securities also takes resources from the private sector. Aside from the budget cost of the program, a tax increase would impose an additional baurden in the form of increased disincentives to work, save, and invest.

Futhermore, it is possible that the largest share of a tax increase would fall on capital formation. By impairing capital formation, the tax would tend to lower long-term economic growth and the living standards of all Americans. To the extent a tax increase hampered economic growth in the short run, it would limit the expansion of the tax base and generate additional safety net expenditures. In short, by lowering revenues and boosting outlays, a tax increase might not reduce the deficit much, and could conceivably increase it. Moreover, if the economy is as anemic as some pessimistic economists think, a tax increase could push the economy into recession.

THE NEED FOR STABLE, PREDICTABLE POLICY

Stability is one of the most important—but least frequently achieved—objectives of economic policy. In order to make efficient economic decisions, people must have reasonably correct ideas of what governmental policies will confront them in the future. Will profits be heavily or lightly taxed? What forms of income will escape taxation? Will interest rates be pushed through the roof? Which forms of economic activity will be regulated or left alone? Will inflation make hash out of investments?

Unfortunately, U.S. economic policy has for some time been a major source of economic uncertainty.

Uncertainty is costly. If businesses and individuals lack confidence in the future, or act on wrong information, they will make the wrong decisions and waste economic resources. The consequences of such waste can be large. For example, the Blue Chip survey of January 1986 reported that uncertainty concerning the results of tax reform is the number one negative factor in the economic outlook. One prominent economist said that tax doubts may have clipped half a percentage point off of economic growth last year.

How does uncertainty affect the economy? Still using as an example, some investment has been delayed this past year pending results of tax reform, and this investment slowdown retards growth. Other investments—office-building construction, for example—are being rushed to best suspected changes. Such investment is largely misdirected and wasteful, since it is encouraged by artificial tax considerations rather than by the real rate of return.

Uncertainty over taxes is nothing new. In 1981, the sweeping Economic Recovery Tax Act was seen as a fundamental reform. But in a year a new bill had reshaped many of its provisions, and it got another facelift in 1984. These three tax bills changed 2,313 provisions in the tax code.

Or consider the desultory history of the major tax provisions. The investment tax credit was introduced in 1962, suspended in 1966, restored in 1967, repealed in 1969, reinstated in 1971, and increased in 1975. Even though it was "made permanent" in 1978, it is now slated for another repeal. Capital gains taxation has ridden a roller coaster almost since the first income tax law in 1913. Every current tax proposal treats capital gains differently, and the Administration's May 1985 tax plan significantly revised its earlier proposal.

Ironically, frequent changes in the code have detracted from the effectiveness of well-intentioned tax incentives. Taxpayers have become wary of such bait as tax credits for investment, R&D, and energy conservation which may be snatched away with little warning.

Rapidly changing tax policy is but one example of the instability that has became endemic in our economic policy. Federal spending—once viewed as a "policy instrument" capable of "fine-tuning" the economy—is more like a stone axe than a scalpel. Anti-recession spending programs have usually been delayed until the economy has recovered, at which point they fuel inflation. More than 30 years ago, Milton Friedman argued convincingly on theoretical grounds that countercyclical fiscal policy was far more likely to aggrevate instability than to smooth it, and since then history has confirmed his theory.

Since the early 1970's, much of the trouble in our traditional manufacturing sector can be traced to instability in aggregate demand, much of which resulted from stop-and-go monetary and fiscal policy. Instability slowed investment in plant, equipment, research, and development, thereby reducing productivity growth and hence international competitiveness in manufacturing.

Since 1979, monetary policy (as measured by changes in the money supply) has varied significantly from quarter to quarter. This was discussed in our August 2, 1985 report. Although the Federal Reserve has been successful in reducing the rate of inflation, its overall performance would have deserved more praise had it been steadier.

Governmental regulations became an important source of uncertainty during the 1970's. Presently, the unpredictability of the course of deregulation has somewhat diluted the benefits of that process.

The Reagan Administration appreciates the need for long-term, stability. Some in the Administration have espoused steady growth of the money supply, and certainly no "fine-tuners" have emerged as managers of fiscal policy. Yet circumstances have made a certain degree of tumult unavoidable. The Administration took office when inflation, interest rates, spending, and tax rates were all far too high, and a smooth transition on all fronts would have required perfect skill in policy, if indeed such perfection was even possible.

At best, we can hope for a better perception among policymakers that stability is essential for strengthening the expansion. This would mean that policy goals on, say, tax reform would include constructing a tax code that would not need to be changed frequently. More specifically, a change-resistant tax code would be one with a broad tax base, so that revenues could be adjusted with very small changes in rates, so small that incentives would not be changed much.

In other areas, such as regulatory matters, stable policy would be much easier to achieve in a regime of relatively light regulation. When heavy regulation is pervasive in the economy, changes in regulations will clearly have greater significance and cause more uncertainty.

In budget policy, we need to agree upon a plan of deficit reduction that is believable in financial markets. The GRH deficit reduction act has been of great value already, but it will be necessary for the Administration and Congress to demonstrate their commitment during the years ahead.

IV. LENGTHENING THE EXPANSION

The expansion must continue through 1991 if we are to have a fighting chance to balance the budget. This, we believe, will require policies specifically attuned to lengthening the expansion:

Avoid a slowdown in growth of the money supply and an increase in interest rates—the usual reaction to accelerating inflation and signs that an expansion will soon end.

Reform the tax code to enhance capital formation and incentives to work.

Adopt trade policies that will stimulate exports and strengthen the world's trading system.

Eliminate Federal regulations that hamper growth.

Pay particular attention to measures to improve productivity and foster individual innovation.

MONETARY POLICY

Previous expansions in the U.S. economy have ended soon after growth in the money supply slowed and interest rates rose. This regularity has been observed fairly consistently worldwide for many decades. In spite of the puzzling changes in this decade among the statistical relationships of gross national product, the growth rate of monetary aggregates, and the current level of interest rates, there is every reason to believe that this relationship still holds. On the other hand, with appropriate policies there is every reason to believe that the present expansion can be sustained.

The current rates of growth in the monetary base and M-1 are very large by historical standards, as was discussed in the previous chapter, but this statistical anomaly alone does not justify a change in monetary policy in the direction of tightening. If the trend rates of monetary growth should happen to increse during 1986, or if other indicators should happen to signal a return of inflation, the Federal Reserve will have to take steps to prevent inflation. These anti-inflationary actions will lead to an economic slowdown and possibly a recession. This unfortunate result should and can be avoided.

Better operating procedures can also help avoid the return of inflation. Current operating procedures, however, are procyclical, meaning that they tend to respond to an increase in the rate of economic growth by amplifying it. Similarly, any decrease in the rate of economic growth is made deeper and more severe.

What is needed is an inherently countercyclical operating procedure. Former Federal Reserve Chairman William McChesney Martin used to speak of "leaning against the wind," and that is indeed the philosophy that must be followed to ensure enduring, non-flationary growth.

From the earliest research in business cycle theory, the goal was to identify the causes of upswings and downturns in economic growth. The Keynesian interlude partially eclipsed the long-known relationship between monetary phenomena and the business cycle, but the validity of the monetary relationship has been strongly reestablished by rigorous theoretical and empirical research in recent years.

Essentially, when monetary authorities increase the monetary base they necessarily increase the pool of liquid capital in the economy. Since the increase in liquid capital is not related to any change in the preference of consumers for different products and services, and since the members of the economic system have not otherwise made any changes in their behavior as to allocation of income between savings and consumption, the increase in liquid capital from the monetary authorities has an impact on the system that has to work itself out. An increase in the monetary base expands the ability of the banking system to make loans and thereby create money. In this sense, it looks like an increase in the pool of savings, which entrepreneurs and capitalists can use for launching new investment projects or expanding old ones, or which consumers might dip into to finance consumption—new homes, consumer durables, vacation travel, etc.

The reverse process, when the monetary authorities cause a decrease in the monetary base, is a decrease in the pool of liquid capital. Such a decrease is also not related to the allocative decisions of individuals in the market, so that relative 'shortage" of liquid capital must work itself out.

It is a truism that the major task of an economic system is to coordinate the plans and activities of millions of people who, for the most part, have no direct contact with each other or any way to communicate economic information except through market signals—prices and relative price changes, non-price rationing behavior such as queuing, backlog delays, inventory imbalances, search techniques, etc.

The major challenge for monetary policy is to promote the coordination of the free market system. It must not be a disruptive force. In particular, it should not foster unrealizable plans by businessmen. If, for example, businesses make plans assuming stable prices, inflation will turn these plans into resource-wasting debacles.

Virtually every recommended strategy in monetary policy is intended to address this issue of facilitating rather than disrupting the market coordination process. Monetarists call for a slow and steady rate of growth in one or more summary statistics, such as M-1 or the monetary base. Most non-monetarists advocate interest rate smoothing, i.e., the targeting of a range of interest rates or some other aspect of the bond market. Both groups have as implicit goals the continuity of a desirable status quo.

For the monetarists, the idea is to give the market some exogenous benchmark such as the quantity of money and let businessmen and consumers arrange their affairs any way they choose in light of that kind of certainty—even if the demand for money should change. As a result, money-supply targeting can be potentially destabilizing in the short run.

For the non-monetarists, the idea is to give the financial markets some notion that interest rates will not change very rapidly beyond some familiar range. In this way, the financing of business—certainly one of the most important coordinating activities in the free market system—would presumably be stabilized. The problem with interest rate smoothing is it is always a relative process, a process with no anchor in the real economy where business planning must ultimately be successful or fail. As a result, interest rate smoothing turns out to be destablizing in the long run. The Federal Reserve can determine either the direction of changes in interest rates, or the direction of changes in the money supply, but not both.

The element of truth in all of these theories is the need for a clear policy everyone can understand and in which confidence can be placed.

The reform in Federal Reserve operating procedures that is needed to sustain and lengthen the current economic expansion, without driving the U.S. economy off of either side of the straight and narrow path, would combine several elements.

First, the criteria for monetary policy should be made explicit and should be internally consistent. Any set of criteria made up of multiple variables, but which are impossible to reconcile simultaneously with the limited tools available to the Federal Reserve, cannot meet this test. The Federal Reserve, as an institution of the U.S. Government, should be held responsible for its policies and actions. Since the task of adhering to a consistent and predictable monetary policy requires a large degree of independence in the execution of whatever policy is seen to be in the public's long-range interest, accountability must be in the form of some measurable performance standard. What's needed is explicit debate over the appropriate criteria for setting monetary policy. Development of a consensus about the criteria for monetary policy will provide accountability through the forum of public and professional opinion. Proposals to place the Federal Reserve under a more direct control by the Administration or the Congress are clearly inappropriate because that would create greater uncertainty about the long-run stability of monetary policy.

Second, whatever long-term trend has been observed over a period of approximately one year, or six quarters, in the monetary base should be used as a presumptively optimal rate of monetary expansion for the succeeding quarter. The monetary base is recommended as the variable to choose for this policy because the Federal Reserve has a direct control over its rate of growth. When the Federal Reserve lends a dollar through the discount window or issues a dollar by purchasing securities through the open market desk, the monetary base increases by exactly one dollar. This direct control is not possible with other monetary aggregates such as M-1 or M-2 because they depend on borrowing demand by the public at financial institutions. Even though there may be some correlation, however uncertain or lagged, between the other monetary aggregates and gross national product, only the monetary base (which is at least one essential, causal factor in all the other monetary measures) is directly controllable by the Federal Reserve. For purposes of accountability, as indicated under the primary criterion above, the Federal Reserve must focus only on measures of performance for which it has direct responsibility. It would be both unfair and ineffectual to use any other standard.

Third, the Federal Reserve should conduct daily open market activity in a manner so as to smooth fluctuations in the Federal funds rate—the rate on that part of the monetary base that banks and other financial institutions lend to each other for very short periods of time. The objective here should be distinctly secondary to the smoothing of the growth trend in the monetary base. There is an unhealthy focus in the financial community on Federal Reserve policy decisions that affect the movement of interest rates. It would be desirable for the Federal Reserve to develop operating procedures that would not require the transmission of monetary policy primarily through the very sensitive Federal funds markets.

Fourth, the international position of the U.S. dollar has become more and more a factor in the debates about monetary policy in recent years. Not only does the exchange rate for the dollar have an impact on domestic manufacturing and our trade balances, it has an impact on the world capital markets. The surprising strength in the dollar since 1981 has been due, in large measure, to capital flows between the United States and the rest of the world. Not only has there been a reduction in U.S. lending abroad, leading to supply and demand pressure that bid up the dollar rate abroad, but there has been an increase in foreign direct investment in the United States, drawn by the profit opportunities created by the tax reform of 1981 and the resolve on the part of the Administration and the Federal Reserve to halt inflation.

In an age when every consumers and businessman used only the currency of his own nation, and alway exchanged it for foreign currency when dealing abroad, the idea that monetary policy might be set by a government independently of foreign monetary supply and demand might have been justified. Today, it is obvious that the U.S. dollar is held overseas by foreign nationals for purposes of both investment and transactions, and that this new source of monetary demand has an impact on the appropriate policy for the U.S. money supply. There is no way to measure foreign demand for U.S. money directly. We don't collect statistics on all foreign holdings of dollars—in many cases, bank secrecy laws make it impossible even to try.

Indeed, the Federal Open Market Committee seems already to rely upon information about the international demand for this Nation's money as a factor in determining its proper growth rate. The Chairman of the Federal Reserve testified before the House of Representatives Banking Committee on February 19, "the judgment of the Federal Open Market Committee as the year developed was that the rather strong restrictive action that would have been necessary to maintain M-1 within its targeted range was not justified. . . . For much of the year, the dollar remained high, and that fact was another strong signal that monetary policy was not unduly liberal."

Another important source of foreign influence on the "correct" U.S. monetary policy for long-term sustained growth is the demand for U.S. currency, which is known to be significant. In some parts of the world, where local governments are unstable or predatory, or where local currency is abusively inflated, the U.S. dollar functions as a parallel currency. The *Federal Reserve Bulletin,* February 1986, reported the results of a study of public demand for currency. The results are startling:

Unless respondents have severely understated their cash holdings, more than 85 percent of the U.S. currency stock outside depository institutions was held—apart from some that may the lost and unaccounted for—by other agents such as business enterprises, persons in other countries, and persons aged less than 18 years. It does not seem likely that children could have held cash inventories much greater than the total holdings of adults. In addition, the cash holdings of businesses generally consist of cash received from sales and inventories of cash held for making change and minor purchases. Because there are strong economic and safety incentives to minimize cash holdings, legitimate businesses are not likely to hold much more cash than all adults. Therefore, the survey results suggest that a large proportion of the U.S. currency stock is held either in hoards, "underground," or offshore and thus for purposes not directly related to measured domestic economic activity.

This finding alone could partially explain the downward drift in monetary velocity discussed in Chapter III, because the velocity statistics are calculated as a ratio of domestic gross national product (or domestic final demand) to what is essentially a multinational money supply.

It is very important in developing criteria for monetary policy to know what it is that our statistics are actually measuring. At present, all currency outside depository institutions is counted as part of the domestic monetary base. Clearly, there should be some effort made to adjust this measure to account for U.S. currency abroad. If the gross national products of all those smaller nations that rely heavily on the U.S. dollar for domestic transactions were added into the monetary velocity calculations, perhaps the recent statistical behavior would not be so puzzling.

TAX REFORM FOR CAPITAL FORMATION AND ECONOMIC GROWTH

As pointed out in previous annual reports, the current income tax system is a barrier to capital formation and economic growth. This has generated support for tax reform in both political parties. It is especially encouraging to note that reduction of still high marginal tax rates is now seen as a major goal, whereas a few years ago it was not. Virtually all tax reform plans would sharply reduce marginal tax rates for both individuals and corporations.

Last December the House passed the Ways and Means Committee tax bill, H.R. 3838. This measure would lower the top personal rate to 38 percent and drop the top corporate rate to 33 percent. Unfortunately, however, in a number of ways the bill would aggravate existing tax biases against capital formation. The repeal of the investment tax credit and the lengthening of capital recovery periods were not compensated by sufficient incentives to prevent an increase in the effective tax rate on investment. Consequently, this measure would undermine capital formation and economic growth.

We recommend that future tax reform include several crucial features. First of all, the top personal tax rate should be as low as possible. With a sufficiently broad base, we believe the top rate could be 30 percent or perhaps even lower. Secondly, the personal exemption should be $2,000 for all taxpayers; itemizers should not be discriminated against. Thirdly, any tax reform must include adequate incentives to avoid a rise in the cost of capital. If the investment tax credit is to be repealed, then there should be compensating changes to make sure that investment incentives remain. One option would be to liberalize depreciation schedules. Even more fundamental changes—such as expensing part or all of capital costs—should be considered. The capital gains differential should be preserved because of its crucial role in encouraging entrepreneurship and fostering innovation.

Though many individual provisions of the code promote inefficiency by encouraging the misallocation of resources, the most fundamental problem is the inherent bias of any income tax system against saving and investment. Under an income tax, both saving and the return to saving are taxed, while consumption is taxed only once. This double taxation of saving increases its price relative to consumption, thereby undermining incentives to save. A neutral tax system, on the other hand, would tax consumption and saving on an equal basis.

By penalizing saving and investment, the income tax lowers both productivity and economic growth, thus eroding the American standard of living. Growing realization of this fact is probably the main force behind the increasing support by economists for consumption taxation. The principle of consumption taxation is quite simple: Saving should be removed from the tax base. There are a variety of different ways to structure a consumption tax including a consumed income tax, retail sales tax, and value added tax (VAT).

The virtue of a consumption tax is that it is more neutral than an income tax. Under consumption taxation, relative prices are unaffected and allocative efficiency unhampered by distortion arising from the differential taxation of saving and consumption under an income tax. The relative price of saving and consumption are changed from that of a no-tax world.

Another benefit of consumption taxation is its nondiscriminatory treatment of different saving patterns. Under an income tax the timing of saving and consumption can generate different tax results. For example, a person who saves early in life will pay more taxes during a lifetime than a similarly situated person who spends heavily early in life and saves only later. Though the two individuals may begin with equal endowments, the double taxation of saving ensures that the saver will incur a greater tax liability over his lifetime.

For these reasons, the Senate should consider a tax reform along the lines of the Roth consumed income tax or the Symms-DeConcini "flat" tax, which is another variant of consumption tax.

The example of Japan illustrates another approach to consumption tax reform. While sweeping consumption tax reforms may have considerable appeal, Japanese tax policy illustrates how easy it is to advance in this direction using only a piecemeal approach. Over the last three decades or so, the Japanese have introduced a variety of schemes, particularly in their personal income tax, to extend consumption tax treatment to saving and investment. These measures were introduced by the Japanese government with the intent of increasing saving and investment. These savings incentives, along with other factors, have contributed to Japan's high personal savings rate and, hence, to that country's rapid rate of capital formation.

One form that these incentives take is the exclusion of interest earned on most depository accounts of about $16,400 or less. Furthermore, though three such accounts are legally permitted, the authorities do not vigorously enforce the limit. This officially condoned tax evasion is so widespread that the number of such tax-favored accounts is about twice the entire population of Japan. Furthermore, a special tax rate is available at taxpayer election for investment income. Currently, this rate is 35 percent, but it has been much lower in previous years. Another interesting feature is the virtual exclusion of capital gains from individual income taxation. All these items encourage saving, investment, and risk taking.

THE TRADE AGENDA

Continued economic recovery in the United States depends largely on a restoration of American competitiveness. This will not be an easy task. Since the early 1980's, the United States has generated ever-larger trade and current account imbalances, even while it has enjoyed robust growth at home. In 1985, for example, our merchandise trade deficit was $148.5 billion; or $25 billion higher than 1984's deficit. As a result of the deterioration in the U.S. trade account, America's overall current account position continues to worsen, with an estimated deficit of at least $100 billion for 1985.

The most troubling aspect of America's competitive decline is not to be found in the growing volume of imports, which reflect the continued strength of consumer demand in the United States, but in the decline of U.S. exports. From 1981 through 1985, exports fell from $233.5 billion to $213.1 billion. The result is that, with few exceptions, the United States has lost its surplus position across the board, running the gamut from Japan, Western Europe, and Canada, to Hong Kong, Mexico, Brazil, and South Korea.

The major cause of this turnabout in the U.S. trade account is traced to the erosion of our trade position in manufactured goods, which constitute approximately two-thirds of total American exports. This trend, if anything, accelerated in 1985. While American manufacturers sold $145.4 billion in goods overseas, U.S. purchases of foreign manufactured goods exceeded $258 billion—or a whopping $112.8 billion deficit in the manufactured goods account, which constitutes a $24.2 billion jump over the 1984 deficit in this area. As recently as 1980, the United States ran a surplus in its manufactured goods trade.

What must the United States do to regain the trade initiatives? Two things. The first order of business is for the United States to convince its partners to play a large role in promoting global expansion. Secondly, Washington would also be well advised to pursue more immediate goals, notably, removal of foreign barriers to our exports; the strengthening of GATT more generally; continued devaluation of the dollar; and initiation of more flexible U.S. import adjustment strategies.

Lengthening the U.S. expansion by promoting global growth

America's continued expansion requires an equally healthy, trade-driven global economy. Until recently, the United States supplied this dynamic in the form of huge volumes of imports from its advanced and developing country partners. But the United States is no longer in the position to supply the kind of demand stimulus which it did during the 1983-84 period. Figures released by the Geneva-based General Agreement on Tariffs and Trade (GATT) already indicate that the growth of world trade in 1985 slowed dramatically, expanding by less than 3 percent, versus a 9 percent rate of growth in 1984.

Restrictive import policies in the rest of the world constitute the other major reasons why the rate of expansion of global trade dropped by two-thirds. In Western Europe, for example, flagging industrial performance and outmoded sectoral and labor market policies continue to retard domestic recovery. The result? Contractionary pressures which, in turn, close off the domestic market to competitive imports. Protectionist pressures also exist in Japan, but the major reason why Japan is not playing a larger role in promoting global expansion is to be found in that nation's extraordinarily low consumption rate and resulting capital outflows which, in turn, stem its domestic appetite for imports. In the Third World, misguided domestic economic policies and staggering external debt burdens constitute the major causes for import cutbacks.

A dramatic reversal in America's external position will not be brought about overnight. But a badly needed spurt in world trade could provide a necessary impetus to the eventual restoration of the U.S. current account balance. How is this to be achieved? A number of developments would have to converge. First, the "surplus" countries of West Germany and Japan need to initiate bolder fiscal (tax) and monetary policies—the kinds which promote a major expansion of domestic demand. Up to now, however, these prospects remain uncertain. In response to U.S. pressure, the Nakasone government has announced a package of domestic stimulatory measures while supporting a small drop in the discount rate. In West Germany, the Kohl government has likewise undertaken limited "supply-side" initiatives—including tax cuts for individuals and deregulation—in order to boost growth and bring down unemployment. Washington sees Bonn and Tokyo as particularly well-equipped to act more assertively in the cause of global expansion. Last September, it won a concession, however vague, from these premier trading countries and the other Group of Five to pursue economic expansion more vigorously, which includes a coordinated effort to reduce the value of the dollar. In stark contrast with the United States, West Germany and Japan sit astride bulging trade and current account surpluses. Accordingly, West Germany's and Japan's future requirements lie in an inevitable downward adjustment in their trade surpluses (particularly vis-a-vis a contracting United States) which can be met through complimentary supply-side domestic measures that would simultaneously promote both domestic growth and an overall expansion of global trade—in other words, the kinds of steps which the United States took so successfully on behalf of global recovery in 1983-84.

Third World countries also constitute a vital element in scenarios to promote global expansion and a return of external account balance in the United States. Over the past two decades, this diverse area has constituted an increasingly important market for sales of goods, services, and technology. In 1982 (the most recent year for which data are available), Africa, Latin America, and Asia imported $300 billion worth of manufactured products. By way of comparison, the combined total of manufactured goods imports by the United States, Canada, and Japan in 1982 reached $280 billion.

The need to service its growing volume of external debt, however, has forced a number of the larger developing countries to cut back significantly on consumption, including imports. Consider Latin America. "To meet their interest payments," explained one analyst before the JEC recently, "debtor countries have turned their trade accounts around, running large trade surpluses. . . . Countries have found the resources to pay the interest bill mainly by cutting back on imports." Imports for this region have, accordingly, dropped from nearly $104 billion in 1981 to $64 billion for 1985. Further economic contraction in the developing world threatens to further reduce the volume of global trade.

REGULATORY REFORM

Regulations are only useful when they are restricted to the limited areas where the market does not operate properly and then only if the regulatory outcome is an improvement over the unregulated outcome. Regulation in the United States still exceeds this role. By continuing the current process of regulatory reform, the environment in which businesses operate can be improved and the opportunity for future productivity growth enhanced. There are three major approaches to regulatory reform: deregulation, privatization, and increased use of market incentives. These three used in combination can reduce the constraints currently imposed on the free enterprise system, resulting in a more efficiently functioning economy.

Deregulation

Deregulation efforts have been an extremely successful tool of regulatory reform. Recognizing that transportation regulations were serving to limit competition rather than protecting consumers from natural monopolies, Congress acted to deregulate much of this sector beginning in the 1970's. The airline industry, deregulated in 1978, now serves more customers at lower fares with a wider choice of carriers and service than existed during the regulatory period. The Motor Carrier Act of 1980 has produced increases in entry into the trucking industry, and as a result prices have dropped significantly. Railroads, freed to lower prices after the 1980 Staggers Act, have reversed their trend toward extinction and are now becoming viable competitors in many transportation markets. The Administration has continued the deregulation of this sector with the substantial deregulation of intercity buses in 1982 and is currently proposing further truck deregulation. Deregulation should be continued, but carefully, in the transportation sector and in other sectors such as communications that were previously thought to be somehow immune to competitive pressures.

Not all the effect of deregulation have been positive, however. Rural areas, with lower population densities and vast distances, were more likely to be disadvantaged by deregulation of services such as transportation, telecommunications, and banking. "Market forces" do not automatically provide autonomous, minimum levels of services at costs comparable to those paid by urban consumers. Competition is the key ingredient cited for the successful deregulation of certain industries. But competition has not come to all markets; consequently, neither have the benefits.

About 60 million Americans reside in rural America. Their ability to obtain services at affordable prices oftentimes hinges on the degree to which the Federal Government assists in the provision of those services. Few would argue that a strong national network is not integral to economic growth and social well-being. The economic, geographic, and demographic diversity of the United States presents an obstacle for wholesale deregulatory efforts. A more prudent approach calls for gradual changes in regulatory policy that recognize and minimize the disadvantages caused by market failures.

Deregulation is also necessary in cases where regulations have been used to supercede the market mechanism and artificially change relative prices. The problems inherent in this type of manipulation can be seen in the energy controls of the 1970's. In order to protect consumers from rising energy prices, Congress held prices below market levels, but at these low prices consumers were using "too much" energy. Therefore, to force energy conservation, Congress mandated energy efficiency requirements for automobiles. Two sets of regulations with two sets of enforcers and Congress in the middle attempted to produce the market clearing combination.

The problems of economic regulation can be clearly seen in the distortions that remain in the natural gas markets. Natural gas' close substitute, petroleum, was deregulated by the President eight months ahead of schedule in January 1981. This deregulation spurred domestic oil production, contributed to the reduction of oil imports, lowered oil prices, and eliminated the costly and inefficient allocation system designed to respond to the manufactured shortages. Natural gas, on the other hand, has not been freed of the artificial categories and pricing system for its old gas, new gas, deep gas, and shallow gas. As a result, the Federal Energy Regulatory Commission (FERC) continues to play a catch-up game of addressing the problems of shortages and surpluses that result from changing world supply and demand conditions.

Privatization

Another tool of regulatory reform, privatization, involves the sale of Federal assets or the turning over of government functions to private industry, particularly in those cases where the government now competes with the private sector. The Administration currently has several "privatization" proposals in the fiscal 1987 budget. These include the sale of the five power marketing administrations and two Naval petroleum reserves, increased sales of government surplus property, elimination of Amtrak subsidies, and the turning over to private firms of the Federal Housing Administration (FHA) and the Overseas Private Investment Corporation (OPIC).

In cases where complete privatization is not possible because of the public good nature of the service provided or its income redistributive goals, partial privatization through contracting out or the use of vouchers can still bring about increases in efficiency with a corresponding decrease in cost. Privatization results in increased efficiency through three sources. First, privately owned businesses are managed more efficiently than government-owned businesses because of an increased pressure to survive. Second, the monoply constraints the characterized government production are reduced. Third, the chance for distortions due to hidden subsidies are limited.

Increased use of market incentives

After reducing the government's regulatory involvement in the economy through deregulation and privatization, the efficiency of the remaining regulation should be improved through the increased use of market incentives. As described in the President's *Regulatory Program of the United States Government,* Federal regulations serve three primary functions; to maintain and protect the health and safety of the public and the environment, to protect the market system through economic regulation, and to provide efficient management of Federal funds and property.

Health, safety, and the environment. Federal regulation in these areas is important and necessary, but too often the regulations as they currently exist either fail to achieve their objective or cause unnecessary distortion. For example, Federal Drug Administration (FDA) testing frees individuals from investing considerable resources on the highly technical information required to make a decision on the safety and long-run effects of a given drug or chemical encountered in the workplace, but unduly slow approval procedures keep safe and effective new drugs from those who need them. Likewise, pollution regulations are meant to cause the producer to consider the full cost of manufacturing, including social cost, but if the regulator specifies how the pollution should be removed, e.g., scrubbers in smoke stacks, rather than the required end result, then producers are not able to make the most cost-effective decision.

These two examples illustrate the two types of regulatory reforms that would bring increased efficiency to the regulatory process through market incentives: streamlining and eliminating command-and-control regulation. Many current regulations are actually combinations of rules that have been patched over the years with newer sections replacing parts or amending earlier regulations. This has resulted in a system so confusing that compliance, particularly in light of new technologies, may be impossible.

Replacement of command-and-control regulations with regulations that specify the required result will help remove the government from legislating technology. This approach would also help reform the number of overlapping regulations required to prevent circumvention of the regulations. For example, a factory may comply with a rule that specifies the amount of a cetrain pollutant that may be released into the air by increasing the pollutants it discharges into a river. Total pollution is not reduced in this case unless all contingencies are covered. Applications of the bubble policy of regulation should be increased, allowing producers to decide how to lower pollution levels.

Economic regulation. Regulation of business and industry was originally intended to prevent firms either through coordination or because of natural monopoly status from restricting output and charging monopoly prices. However, economic regulation has been misused and overused in the past, resulting in a lessening of competition, protection of inefficient firms, and stifling of innovation. The antitrust laws in particular have become a weapon that a less efficient firm can use against a more efficient competitor. There has also been an attempt to control foreign competition through regulation beyond the current protection from dumping or subsidization of imports by trying to impose quotas or tariffs. When the antitrust and trade laws are manipulated in this manner the net result will be decreased productivity.

Federal management. Because the Federal Government avoids the rigors of the market system, particular attention must be paid to the management of its funds and resources. We applaud the Administration's efforts to improve the capacity and effectiveness of Federal management systems and, moreover, to enable the managers themselves to become more productive. As a first approximation of market efficiency, there should be an increase in quality control systems designed to improve the allocation function including targeting and accountability for all types of expenditures and credit assistance. However, the more general solution to problems of bad management is to inject the discipline of the market into government operations. This means taking advantage of all cost-effective opportunities for privatization.

INNOVATION AND PRODUCTIVITY

The following paragraph cites facts which are accepted by every economist who has studied productivity and innovation:

Productivity growth is fundamental to economic growth and to the Nation's ability to compete in international markets. Technological progress and innovation are the most important sources of productivity growth. Industrial research and development, plus basic research at universities and in government laboratories, are the foundation of major innovations and new technologies. In addition, numerous high-tech advances have been conceived and brought into economic successes by individuals entrepreneurs backed by venture capital.

Indeed, these unexceptionable statements verge upon cliche. Such truths are frequently restated by Presidential commissions and by various blue-ribbon panels of prestigious citizens, and no one ever disputes them. Thus, it would seem that these facts should be cornerstones of long-term economic policy.

But when it comes to actual policymaking, these fundamentals sometimes get trampled in the stampede to solve the policy crises of the moment. Even tax reform—conceptually an exericse in building a framework for fostering long-term economic growth—gravitates to detailed consideration of who gets what in the short run.

Neglect of productivity and technology is particularly dangerous at present. While the United States is a very productive and innovative nation, there is no guarantee that it always will be. Some warning signs are apparent:

Productivity in the nonfarm business sector was unchanged from 1984 to 1985. While it is true that productivity gains usually diminish at this stage of the business cycle, it is worrisome that productivity has grown only 3.4 percent since 1978. In fact, productivity growth since 1973 has limped along at an appalling average annual rate of just under 0.7 percent.

Industrial spending on research and development seems to have recovered from its slump of the 1970's. But recent spending figures are unimpressive, particularly when we lack price indices to tell us how much of the increases in spending has gone to increase "real" R&D rather than to simply offset increases in the cost of performing R&D.

The figures are even more ominous when viewed along side those of our international competitors.

Our productivity growth is the worst among industrial economies. In rankings of Labor Department data on the growth of "gross domestic product per employed person" for the nine leading industrial nations, the United States is at the bottom of the list for *every* period of interest: 1950–84, 1960–84, 1970–84, 1960–73, 1973–84, and so on.

Our support for research and development is not impressive in comparison with that of our rivals. Considering the ratio of R&D spending to gross national product, we are on about the same level as Japan and West Germany. But we spend a much larger portion of our R&D funds on military research, which provides only limited benefits to the economy. In civilian R&D as a percent of GNP, we trail West Germany and Japan by significant margins.

Technological change is particularly important to the United States, as we apparently possess a comparative advantage in producing goods which result from R&D and which require highly educated labor in their design and production. By and large, our high-tech industries are much more active exporters than our basic manufacturing industries.

What can be done to spur our lagging productivity and to make sure that our research and innovation do not slip further? Some who have recognized these problems have proposed massive governmental interventions under the rubric of "industrial policy." This is based on the notion that the government can identify investment opportunities more quickly and more effectively than can private markets and should therefore allocate resources to favored industries and regions.

We reject this approach. As we have explained in previous reports, industrial policy is likely to be a totally ineffective approach to any economic problem. It is particularly unsuitable for stimulating innovative activity. The free market is by far the most efficient incubator for innovation.

In fact, one of the benefits of the "high-tech" revolution is a renewed appreciation for the free market. So many of the new high-tech products have originated with lone American entrepreneurs that European nations are seeking to establish their own venture capital markets and their own entrepreneurial culture.

The general approach to the problem of technology and productivity must be one of removing impediments to innovation and letting entrepreneurs find their own way in a free market with a favorable business climate. The government has a role in funding *some* basic research and in providing *some* of the support to university research, but it should leave commercial R&D to private industry.

The most important aspect of the business climate (aside from the long-term rate of economic growth) is the tax environment. In the current debate over tax reform, the issue of capital formation is receiving a lot of attention, and this issue is doubly applicable to technology. High-tech industries typically have high rates of capital formation, so they are relatively sensitive to changes in tax provisions which affect the cost of capital. More generally, U.S. high-tech companies are essentially capital goods producers, meaning that they flourish when capital formation in the industrial sector is rapid. As capital formation goes, so goes high-tech industry. The capital gains differential is particularly important, not just as an aspect of the tax rate on capital, but because it has proved to be such a potent force in encouraging innovation and improving the availability of venture capital.

The supply of saving is also important in capital formation. For some years, U.S. savings rates have been significantly below those of other industrial countries (most notably Japan's), and consequently we have had to borrow from abroad. Though the capital market worldwide is fairly well integrated, our relatively low supply of domestic savings is one of the forces that makes the cost of capital high in the United States. As mentioned in Chapter IV, the tax system penalizes saving. Most of the current proposals to reform the tax code recognize the need to encourage savings, and it is important to give these proposals careful study. Capital formation issues—affecting both saving and investment—must continue to receive careful consideration in overall tax reform.

The House Republican Research Committee's task force on high technology initiatives has published a list of specific legislative actions that could be taken to foster innovation. (See *Targeting the Process of Innovation: An Agenda for Meeting America's Competitive Challenge,* December 1985.) We endorse these recommendations. These actions would avoid the problems inherent in "industrial policy" because they deal mainly with the environment for innovation and do not set up a bureaucracy to intrude in private decisionmaking.

The recommendations fall under four main categories:

Basic research and development. Actions are recommended to encourage Federal laboratories to enter into cooperative research and development agreements.

Incentives for risk taking and capital formation. Here the Committee proposes reform of the tax code to reduce the cost of capital. They recommend lower marginal tax rates on both personal and corporate income and on capital gains. They recommend that the tax credit for R&D be made permanent.

Adequate supply of skilled people. Here the emphasis is on training incentives rather than expensive new programs.

Expanding market opportunities. Along with actions to crack down on unfair trading practices of foreign nations, the Committee recommends that the Federal budget deficit be reduced. This is in line with our concerns about how budget deficits will threaten capital formation.

This section has summarized both general and specific policy actions that can lengthen the expansion by helping productivity and innovation. We hope that these concerns will achieve the prominence they deserve in current policy debates.

V. Broading the Expansion

As gratifying as the 1983-86 economic expansion has been, we must not ignore the plight of sectors that have not prospered with the rest of the Nation.

The poverty problem—though diminished—remains extremely serious.

Some of our industries have suffered from foreign competition, and our trade policy must deal with this problem.

Agriculture is in terrible shape, and our farm policies still are not properly designed.

Rural areas, which are lagging far behind the rest of the Nation, have been virtually ignored by Federal policy.

INCOME DISTRIBUTION

Considerable conflict and confusion surroundings the issue of the trend in real median family income since 1973. Let us consider the relevant data. Table V.1 shows the annual figures for real median family income. Real median family income declined each year between 1978 and 1982. The largest drop, $1,529 occurred in 1980. This trend was reversed in 1983. Between 1983 and 1984, real median family income increased $839, the largest increase recorded during this period. We anticipate that real median family income for 1985 will be significantly higher than during the previous year as well.

TABLE V.1.—MEDIAN FAMILY INCOME

[1984 dollars]

1973	$28,167	1979	$28,029
1974	27,175	1980	26,500
1975	26,476	1981	25,569
1976	27,293	1982	25,216
1977	27,440	1983	25,594
1978	28,085	1984	26,433

Another statistic used to analyze income is median income of families with children. As can be seen from the table below, movements in this series closely follow those in the previous table.

TABLE V.2.—REAL MEDIAN FAMILY INCOME (FAMILIES WITH CHILDREN)

[1984 dollars]

1974	28,446	1980	26,931
1975	27,484	1981	25,954
1976	28,335	1982	25,343
1977	28,429	1983	25,359
1978	28,961	1984	26,303
1979	29,019		

By far the biggest drop in this measure of income occurred in 1980. In this year alone the decline amounted to $2,088. The economic force behind this development, as in the previous income trend, was the erosion of nominal income by accelerating inflation in the late 1970's and early 1980's. There was no trend from 1974 (1973 data are not available), and income was higher in 1979 than in 1974. Fortunately, family income climbed in 1983, and was up strongly in 1984. The 1984 increase of $944 was the largest rise in the 1974-84 period. We expect a further increase when data for 1985 are available.

Alleviating poverty

As mentioned in the budget chapter, poverty remains even after hundreds of billion of dollars have been spent on the War on Poverty programs. Indeed, after 1978 the poverty rate started to drift upward. Part of this upward trend is, however, attributable to the overstatement of inflation in calculating the poverty thresholds. (For an analysis of this, see "Mismeasuring Poverty and Progress," by John C. Weicher of the American Enterprise Institute.)

Fortunately, the increase in the poverty rate was broken by a decline of 0.6 percentage points in 1984. We expect this trend to continue in 1985, though these data will not be available until later this year. The strengthening economy may bring further reductions in the poverty rate in 1986.

Though we have made some progress towards reducing poverty under the Reagan Administration, much remains to be done. We commend the President's call for a comprehensive study of the deplorable problem and recommend that the Federal Government take the necessary steps to encourage workfare as opposed to welfare. Furthermore, any tax reform should be structured to provide incentives to those near or below the poverty line to enter or remain in the work force. Above all, policies to sustain economic growth and job creation should be continued. The over 9.5 million jobs created during the expansion demonstrates that the best jobs program is a strong private sector.

Distribution of tax benefits under ERTA

Ever since the passage of ERTA, opponents have argued that it was, crudely put, a "giveaway to the rich." The "unfairness" of the Act was frequently attributed to its even cut of all tax rates, including those at the top, and less often to the accelerated reduction of the top personal tax rate to 50 percent. Supporters of the 1981 Act argued that the distributional issue was secondary to the necessity of improving incentives to work, save, and invest. By lowering the price of saving and investment relative to consumption, and work relative to leisure, the tax cuts would increase the resources available for use in production, thereby increasing aggregate supply and economic growth. Although this policy proved successful in increasing investment and job creation, opponents still complain about unfair tax cuts for the rich. As a result, there remains the widespread perception that the 1981 tax bill enabled the rich to escape their fair share of the tax burden.

The remarkable aspect of the unfairness thesis is that it has any credibility whatsoever. The Statistics of Income (SOI) data from the

IRS totally refute this notion. Extensive hearings and two studies published by the Joint Economic Committee explain why the wealthy might be expected to pay more tax after the top rate was dropped to 50 percent. The studies document that this is what actually happened. Consequently, the share of the tax burden shouldered by the top 1 percentile of taxpayers increased after the tax bill in both 1982 and 1983. Their share of the tax burden increased from 18.4 percent in 1981 to 20.4 percent in 1983, an increase in their tax burden of 11.2 percent. The same thing happened for the top 5 percent of taxpayers. The burden of the other 95 percent of the taxpayers declined. The table below summarizes the changes in tax burden, focusing on the wealthiest 1 percent of taxpayers.

TABLE V.3.—DISTRIBUTION OF THE TAX BURDEN

[Proportion of total individual tax revenues paid by 2 groups]

	Top 1 percent of taxpayers	Other 99 percent
1979	19.97	80.03
1980	19.53	80.47
1981	18.37	81.63
1982	19.68	80.32
1983	20.42	79.58

This development was recently confirmed by a study published by the National Bureau of Economic Research (NBER). NBER faculty research fellow Lawrence Lindsey, in "Taxpayer Behavior and the Distribution of the 1982 Tax Cut" (NBER Working Paper No. 1760), discusses the response of the top 180,000 taxpayers with incomes over $200,000. He found that after the 1982 rate reduction these wealthy taxpayers reported 17 percent more taxable income than they would have otherwise, resulting in additional tax payments and their assumption of a greater share of the tax burden.

Lindsey found that capital gains income and revenues were very responsive to the level of the tax rate. The results were strong enough to imply that the current capital gains tax rate of 20 percent is above the revenue maximizing level. Thus, an increase in the capital gains rate would probably lower revenues.

BROADENING THE EXPANSION WITH TRADE POLICY

In the previous chapter we discussed trade policies to lengthen the expansion. In this section, we consider how to broaden the expansion to industries left behind by the recovery.

Removal of export barriers and a strengthened GATT

During 1985, the United States addressed the challenge of promoting global expansion through a variety of bilateral and multilateral initiatives. On the bilateral level, the United States initiated a number of measures designed to expand the global trade system, including the negotiation of a U.S.-Israeli free trade agreement, which conceivably might also serve as a prototype for a similar arrangement with Canada.

The United States has also been the leading advocate of a new round of multilateral trade negotiations under GATT auspices. The agenda for the next GATT round will include trade in services, rules governing agricultural exports, newly industrializing countries' (NIC) access to Western markets and Western access to theirs, and negotiation of a safeguards code. To facilitate effective handling of these future issues, however, the United States also expects the new round to result in substantial improvement in GATT's "dispute settlement" mechanism. Explains U.S. Trade Representative Clayton Yeutter: "One of the great frustrations of business firms throughout the world lies with their inability to obtain a decisive, expeditious resolution of trade problems. They can take their troubles to the GATT through their respective governments, but there is little comfort in that if a nebulous response emerges five years later. That challenge needs to be faced in the next GATT round."

A related but separate (unilateral) undertaking involves a series of targeted U.S. actions, designed to improve market access for American firms in a select number of countries including:

Self-initiation of actions against trade barriers in Japan, Korea, and Brazil, under Section 301 of the Trade Act of 1974;

Acceleration of Section 301 investigations against the European Community and Japan;

Initiation of a GATT Subsidies Code case against the European Community; and

Stepped-up negotiations to end the counterfeiting and piracy of U.S. goods and processes, and to better protect our intellectual property rights.

The United States also needs to broaden its effort to remove foreign trade barriers—beginning with Japan, which after the United States is the most influential player in the global economy. Tokyo should understand that the very arguments it makes on behalf of market access outside Japan have equal relevance for U.S. firms trying to enter its marketplace.

Even if the present government in Tokyo were fully committed to remake Japanese trade policy in the American image, powerful domestic constituencies in Japan would effectively prevent Mr. Naksone's cabinet from doing so. In reality, the two allies continue to have important differences on how "free" trade should be conducted. Faced with these realities, then, the United States would be best advised to continue expanding on the list of import liberalization measures which Japan is prepared to negotiate with the United States. Over the longer term, these external pressures should in turn encourage the emergence of a more broadly based, internationally minded trade community in Japan.

In fact, Japan has become increasingly responsive to U.S. criticisms of its restrictive import practices. Over the past few years, Tokyo has significantly reduced most of its tariffs. It has also refrained from adopting formal quotas. But the United States is not alone in believing that Japan's formidable system of informal barriers more than makes up for the absence of formal ones. "It is not only the United States that is unhappy with the degree of access to the Japanese market," says Edward J. Lincoln, former executive vice president of the Washington-based Japan Economic Institute, "Virtually every country exporting manufactured goods to Japan has serious complaints; Americans may fail to understand Japan or work aggressively to pentrate its market, as the Japanese allege, but it is difficult to see why everyone else—including, for instance, Korea—should fit this characterization." This assertion certainly holds with regard to sales of Third World manufactured goods to the West between 1979 and 1983. While the United States expanded its imports of these products, moving from 45 percent to nearly 58 percent of the Western total over this period, Japanese imports of Third World manufactured goods actually dropped from 11 percent to 8 percent.

For the United States, two immediate courses of action are required to promote an erosion of those less visible Japanese import barriers: continued encouragement of measures designed to stimulate domestic expansion and a stronger yen, combined with more precise bilateral efforts to promote greater market access for U.S. products. While the United States has taken the initiative on this first set of measures (and will probably have to wait a long time before their impact will be felt on the bilateral trade front), Japan is largely responsible for promoting the latest round of negotiations designed to expand access to the Japanese market; the so-called market-oriented sector specific (MOSS) talks. This round was initiated in January 1985 and initially included four key industry sectors: telecommunications, medical equipment and pharmaceuticals, electronics, and forestry products. The results, while hardly spectacular, have nevertheless been greeted as a step in the right direction by the United States. Modest Japanese concessions were obtained in promoting greater market access for American forest products and electronics. But larger breakthroughs were registered in reducing barriers to sales of U.S. telecommunications and pharmaceutical goods.

Exchange rate realignment

While the ratios of U.S. exports and imports to gross national product are relatively small—5.8 percent and 9.8 percent in 1984, respectively—America's relative dependence on the global economy for a broadening of the domestic expansion continues to grow. Certainly that's the unavoidable conclusion that must be drawn in assessing the future competitiveness of our agricultural, manufacturing, and service sectors. In the case of agriculture, for example, fully one-third of every planted acre is exported to markets around the world. Similar conditions apply to U.S. trade in manufactured goods, where until recently the United States was able to generate sufficient export earnings to balance the curent account. No longer.

On need not be a mercantilist to be concerned about the erosion of the U.S. trade account. From a position of relative "balance" (U.S. exports roughly equalling U.S. imports) through the mid-1970's, the United States' trade posture began to markedly worsen in 1976 when the United States ran a $17.2 billion deficit. By the end of that decade, the merchandise imbalance stood at $36.3 billion. Far and away the most dramatic shift, however, took place between 1983 and 1984, when our trade deficit jumped from $69.3 billion to $123.3 billion. Exports must henceforth grow considerably faster than imports to restore balance in the trade account.

This shift in the U.S. trade posture is the result of two developments. First, the U.S. technological advantage has eroded in the face of the successful modernization strategies of Western Europe, Japan, and a number of Third World countries. But this secular development has, if anything, been accelerated by a second, more immediate factor—namely the rapid appreciation of the dollar which has made U.S. exports more expensive than they otherwise would be, with imports that much less so.

Broadening the U.S. expansion then requires a realignment of the exchange rate. This has already begun to take place in the wake of the September meeting of the Group of Five in New York which set into motion a 20 percent decline in the dollar's value as of early 1986. At this juncture, the question arises as to how much further the dollar "should" fall in order to facilitate an improvement in U.S. export competitiveness. This is a difficult question to answer for two major reasons:

The United States can no longer determine—on its own—the exchange rate of the dollar. "Some causes of dollar strength are either beyond our control or reflect conditions we would not want to change," explains C. Fred Bergsten, Director, Institute for International Economics. Bergsten cites the "safe haven" appeal of the United States (in both economic and political terms), our success in reducing inflation, and our more rapid economic expansion (in 1983/1984).

This realization leads to another point: That in regard to certain U.S. trade partners, a devaluation of the dollar will occur largely as a result of actions they agree to undertake vis-a-vis their own currencies; notably the yen, which would probably have to move to a stable rate of 175 to the U.S. dollar to help facilitate a more favorable exchange rate regime for U.S. firms to effectively compete with their Japanese counterparts. In light of Japan's record export earnings in the American market, it remains an open question whether Tokyo would be prepared to initiate such a dramatic appreciation of its own currency.

To the degree the United States—and its allies—are prepared to coordinate actions to further depreciate the dollar, precisely how much further should the dollar be devalued; and what would be the immediate and long-term effect of such an undertaking?

Two major concerns stand out. On the one hand, as the world's leading market economy, the United States should be extremely cautious in undertaking a devaluation strategy that requires direct central bank intervention. To do so would signal the world that the United States is prepared to act the way chronically indebted Third World countries do whenever their external accounts require short-term correction. On the other hand, some downward adjustment in the dollar's value appears overdue. But over what time period should the dollar be revalued? To select the most unfavorable alternative: a sharp reduction in the dollar's value—a "hard-landing" scenario—could bring about a result which, in terms of U.S. and global stability, would be far worse than the present situation. Explains one analyst: "In a hard-landing scenario, the dollar overshoots, going down by over 40 percent from the baseline, and the U.S. current account goes into a surplus equivalent to 1.5 percent of GNP by 1990. The inflation rate doubles. If the economy were not already in recession, interest rates would have to rise by enough to generate one. Because of what would be, for the United States, an unusual combination of a recession accompanied by a sharp drop in the dollar and accelerating inflation, the well-being indicator would fall to minus 7 percent, its lowest level since the Great Depression."

As of now, the foreign exchange markets indicate that immediate fears of a hard-landing scenario for the dollar are without foundation. If anything, the slide in the dollar's value appears to have been halted. To the degree then that the United States desires further depreciation in the dollar, prudence requires a course of action that addresses those underlying domestic and international realities which are mainly responsible for its rapid appreciation in the first place: Surging budget deficits in the United States, which have required huge inflows of foreign capital to service them, and laggard economic policies in the major surplus countries of Japan and West Germany. The Gramm-Rudman-Hollings budget reduction package—if fully implemented—would eliminate the Federal deficit. Whether our major trade partners are prepared to fulfill their part of the dollar-devaluation bargain remains an open question.

More flexible import adjustment strategies

The recent import surge has brought with it certain benefits to the U.S. marketplace in the form of low-priced, high-quality goods which have in turn helped stem inflation during the 1983–84 boom period. Indeed, with respect to Japan, the country with whom the United States has been running gigantic merchandise deficits, Tokyo's surpluses and Washington's deficits should not be regarded as a zero-sum game, i.e., America's deficit is Japan's gain. Explains the London *Economist:* "The (U.S.) trade imbalance is, of course, a problem. What is less often realized . . . is that Japan and the United States are increasingly becoming part of the same economy, an economy equal to a third of world output. . . . More than a third of Japan's exports go to America, its largest trading partner, while more than 20 percent of America's exports go to Japan, America's second largest partner (after Canada)."

The matter cannot be laid to rest so easily, however. While the overall level of employment has dramatically increased over the past few years, the scale of dislocation accompanying the dramatic expansion of imports has been severe for certain industries. Calls for import protection have reached unprecedented levels. During the first session of the 99th Congress, more than 300 trade bills were introduced. A large percentage of them called upon the U.S. Government to take immediate action to grant import relief or retaliate against those countries engaged in the kinds of alleged "predatory" actions which were responsible for these dislocations in the first place.

Few sectors of the American economy have been immune to the impact of imports. The pattern of displacement—from agriculture, steel, apparel, textiles, to semiconductors—has clearly strengthened the momentum toward protectionism in the United States in 1985. Even if the United States were able to bring about a dramatic reduction in its merchandise trade deficit the demand for import relief would continue to be strong.

For two main reasons, however, resort to outright protectionism would prove more detrimental to the United States: First, such actions would probably trigger retaliatory responses by America's trade partners whose markets continue to offer sizable commercial opportunities for U.S. exports. Secondly, to the degree such barriers helped reduce the trade deficit, they would inadvertently strengthen the dollar, thus undermining future U.S. export competitiveness.

A more sensible U.S. approach for redressing trade-induced dislocations is to be found in the adoption of longer term adjustment strategies. Our trade partners already have such policies. Sensibly conceived, a U.S. version could supply an appropriate antidote to trade restrictive initiatives. Two such recent proposals merit attention: The first is supplied by Senator William V. Roth, senior Republican Member of the Joint Economic Committee, and cosponsored by Senator Daniel P. Moynihan. The United States has a Trade Adjustment Assistance Program. The Roth/Moynihan bill, however, is designed to remedy the chief defect of the existing adjustment system: the absence of an effective job retraining requirement. The Roth/Moynihan bill retains existing provisions which guarantee cash benefits to displaced workers. Their legislation goes one necessary step further, workers would participate in suitable retraining programs during the benefit period. Training costs would be supported by a $4,000 job voucher.

Program financing is provided by a "user fee," paid by those who benefit from trade on behalf of those hurt by it. The maximum fee would be 1 percent; but preliminary estimates place the cost of the new adjustment program closer to one-tenth of 1 percent. Senator Roth's bill was reported unanimously by the Finance Committee and passed Congress last year as part of the Budget Reconciliation legislation for FY 1986. This legislation, however, has not yet been sent to the President.

A second proposal is put forward by Brookings Institution economists Robert Z. Lawrence and Robert E. Litan. They begin with a discussion of Section 201 of the 1974 Trade Law, the so-called "escape clause" which allows relief for as much as five years when a U.S. domestic industry is able to prove before the International Trade Commission (ITC) that it faces serious injury from imports. Under these circumstances, the GATT allows signatory countries to temporarily "escape" from their free trade obligations. Since 1974, 60 percent of those industries requesting escape clause treatment have passed the ITC's injury test. In light of the present magnitude of America's import problem, however, Lawrence and Litan propose to use Section 201 as an import adjustment mechanism. If an industry passes the escape clause's injury criteria, and the President of the United States is prepared to offer relief, they propose that such assistance be in the form of a four-year tariff on the respective imports. A key provision of this proposal is the elimination of quotas or so-called Orderly Marketing Agreements (OMA's). Lawrence and Litan argue that quotas impose hidden costs. Tariffs, however, are transparent to consumers and lawmakers. Perhaps more important, quotas make it easier for domestic producers with market power to increase their prices.

The other major component of the Lawrence/Litan proposal calls for automatic government assistance to workers who have lost jobs to imports and communities that have, as a result, been forced to absorb a major erosion in their tax bases. Revenues derived from tariffs would then be used to assist displaced workers by offsetting some of their lost earnings if they found employment elsewhere for less pay. The clearest advantage of such a proposal is that unlike quotas or OMA's—which offer, at best, short-term palliatives without providing longer term solutions to import-induced disruptions—it would speed adjustment into more competitive areas of the U.S. economy.

The G-5 meeting in New York this past September represents a watershed in U.S. efforts to obtain allied support for a more balanced trade posture for the United States, which can no longer be expected to carry the major burden for ensuring global recovery. Maintaining that new consensus will not be easy. The major engines of growth outside the United States—West Germany and Japan—continue to resist the kinds of expansionary policies which their external surplus situation clearly requires. Huge debt burdens and inadequate market mechanisms throughout the Third World combine to retard the growth of imports. Counterbalancing these trends, of course, is a recent drop in oil prices and a growing awareness that for all of its imperfections, national economic interests are well served by an expanding global economy—not the least of which are the interests of the United States.

AGRICULTURE

By usual definition, two consecutive quarterly declines in real gross national product (GNP) represents a recession. This staggering economic event has occurred once during the last four years, the fourth quarter of 1981 and the first quarter of 1982. There is a comparable figure which measures gross product for the farm sector. Quarterly real gross farm product has declined seven times during the last four years. Technically defined, the farm sector has experienced four recessions in the last four years. While there is no commonly accepted defintion of a depression, a recession in each of the last four years may qualify for consideration. Real net farm income was $11.8 billion in 1984 and is forecast by the Department of Agriculture at between $6 and $8 billion for 1986. Real net farm income in 1929 was $12 billion and in 1933, $6.6 billion. Also, during the decade of the 1930's, the real value of farm real estate dropped 14 percent. The real value of farm real estate has declined 18 percent since 1981. Yet the total number of farms has fallen by but 5 percent since 1981. The financial resilience of farms can largely be attributed to the income earned off the farm by farm households which now accounts for 55 to 60 percent of total farm income.

The degree of financial stress—the "farm problem"—within agriculture is not uniform by type of farm, size of farm, or geographic location. According to a recent Department of Agriculture study, the farms which are experiencing the greatest financial problems are those with debt-to-asset ratios greater than 40 percent and which have a negative or zero cash balance. This study identifies these most stressed farms by size (value of sales), type (grain, livestock, etc.), and geographic location. This appears to be a rational and reasonable definition of the "farm problem" and therefore would be of some use in farm policy formation, including the distribution of any government assistance to lower debt-to-asset ratios and/or to improve cash balances for farmers.

According to the USDA study, 213,775 farms, or 12.8 percent of all commercial farms, have debt-to-asset ratios greater than 40 percent and negative or zero cash balances. These farms form the critical list and represent the core of the farm problem. To give further definition to the farm problem, the 213,775 farms under critical financial stress are classified by sales class, type of farm, and region in Table V.4. Note that two-thirds of the farm problem (as defined here) is concentrated within those farms with sales from $20,000 to $249,999; that three-fourths of the farm problem is concentrated within cash grain, general livestock, and dairy farms; and that 60 percent of the farm problem can be found in the Lake States, Corn Belt, and Northern Plains.

Department of Agriculture data also shows that while farms with sales of $250,000 or more accounted for only 9.1 percent of all critically stressed farms they received 31.2 percent of all direct government payments in 1984.

TABLE V.4. —NUMBER OF FARMS UNDER CRITICAL FINANCIAL STRESS BY SALES CLASS, TYPE OF FARM AND REGION

	Number of farms under critical financial stress	Percent of all farms under critical financial stress
Sales class:		
$500,000 and over	5,444	2.5
$250,000 to $499,999	14,176	6.6
$100,000 to $249,999	47,216	22.1
$40,000 to $99,999	62,004	29.0
$20,000 to $39,999	32,379	15.1
$10,000 to $19,999	19,776	9.3
Less than $10,000	32,780	15.3
Total	213,775	99.9
Type of farm:		
Cash grain	58,798	27.5
Field crop	10,925	5.1
Vegetable and melon	3,612	1.7
Fruit and tree nuts	4,253	2.0
Nursery	1,393	.7
General crop	21,493	10.1
General livestock	63,705	29.8
Dairy	41,542	19.4
Poultry	4,578	2.1
Other livestock	3,475	1.6
Total	213,774	100.0
Region:		
Northeast	11,761	5.5
Lake States	41,123	19.2
Corn Belt	53,739	25.1

TABLE V.4.—NUMBER OF FARMS UNDER CRITICAL FINANCIAL STRESS BY SALES CLASS, TYPE OF FARM AND REGION—Continued

	Number of farms under critical financial stress	Percent of all farms under critical financial stress
Northern Plains	34,423	16.1
Appalachian	13,536	6.3
Southeast	9,374	4.4
Delta States	11,680	5.5
Southern Plains	14,771	6.9
Mountain States	12,532	5.9
Pacific States	10,836	5.1
Total	213,775	100.0

The recession in agriculture notwithstanding, it is not as if government has failed to expand considerable resources in attempting to address the economic difficulties facing America's farmers. Analysis of data compiled from USDA's *Economic Indicators of the Farm Sector: National Financial Summary, 1984*, is enlightening. The following table shows direct and indirect Federal price-support aid to the farm sector for the years 1980 through 1984:

TABLE V.5.—FEDERAL AID TO THE FARM SECTOR—1980–84

[In millions]

Year	Indirect aid	Direct payments	Total
1980	$1,970	$1,286	$3,256
1981	4,216	1,932	6,148
1982	11,644	3,492	15,135
1983	1,862	9,294	11,157
1984	706	8,445	9,150
Total	20,398	24,449	44,847
Average	4,080	4,890	8,969

Despite the large amount of funding devoted to the farm program, however, it is important to recognize that agriculture is made up of a very diverse group of operators. In assessing the effect of any governmental effort to aid the industry, it is necessary to consider how both the benefits and the needs are distributed.

The next table shows the number and percentage of producers in each of nine categories based upon 1984 sales volumes ranging from less than $2,500 to over $500,000 per farm:

TABLE V.6.—NUMBER AND PERCENTAGE OF PRODUCERS BASED UPON 1984 SALES VOLUMES

Sales class	Number of farms	Percentage of farms
$500,000 plus	31,000	1.33
$250,000 to $499,999	77,000	3.31
$100,000 to $249,999	229,000	9.84
$40,000 to $99,999	353,000	15.16
$20,000 to $39,999	247,000	10.61
$10,000 to $19,999	269,000	11.55

TABLE V.6.—NUMBER AND PERCENTAGE OF PRODUCERS BASED UPON 1984 SALES VOLUMES—Continued

Sales class	Number of farms	Percentage of farms
$5,000 to $9,999	314,000	13.49
$2,500 to $4,999	275,000	11.81
Less than $2,500	533,000	22.90
Total	2,328,000	100.00
Total under $100,000	1,991,000	85.52

Over 85 percent of all farm operators sold less than $100,000 worth of farm commodities in 1984, but many of them do not rely upon farming as their principal means of livelihood. Indeed, nearly 60 percent of the income of all farm operators come from non-farm sources in 1984. Presumably, those with higher off-farm incomes have less need for farm income support to sustain their livelihood.

On the other hand, those with higher farm sales might be expected to be able to earn sufficient returns to sustain their farming operations and, therefore, have less need for government aid as well. Net farm income for 1984 and total income per operator with direct government payments subtracted are displayed in the following table:

TABLE V.7.—NET FARM INCOME FOR 1984 AND TOTAL INCOME PER OPERATOR (WITH DIRECT GOVERNMENT PAYMENTS SUBTRACTED)

Sales class	Net farm income/farm [1]	Total income per operator [1]
$500,000 plus	$392,580	$1,539,612
$250,000 to $499,999	61,285	374,025
$100,000 to $249,999	18,912	168,659
$40,000 to $99,999	762	80,022
$20,000 to $39,999	−1,805	50,011
$10,000 to $19,999	−2,338	37,137
$5,000 to $9,999	−1,875	32,503
$2,500 to $4,999	−2,345	27,778
Under $2,500	−1,701	27,395
Average	7,833	84,783

[1] Without subsidy

Even without direct government payments, the largest farms were very profitable in 1984. The smallest farms were unprofitable, but farming appears to be a sideline business or a hobby for these operators. As seen in the following table, off-farm income constitutes over 100 percent of the net total income of the operators of farms with sales of less than $20,000:

TABLE V.8.—OFF-FARM INCOME AND PERCENT OF NET INCOME PER SALES CLASS, 1984

Sales class	Off-farm income (millions)	Percent of net income per class
$500,000 plus	$451	3.30
$250,000 to $499,999	883	12.29
$100,000 to $249,999	2,453	25.11

TABLE V.8.—OFF-FARM INCOME AND PERCENT OF NET INCOME PER SALES CLASS, 1984—Continued

Sales class	Off-farm income (millions)	Percent of net income per class
$40,000 to $99,999	3,431	61.55
$20,000 to $39,999	5,209	98.17
$10,000 to $19,999	4,773	109.05
$5,000 to $9,999	6,326	108.27
$2,500 to $4,999	5,348	112.95
Less than $2,500	11,139	108.55
Total	40,013	59.97

During debate on the 1985 farm bill, Chairman Helms of the Senate Agriculture Committee called the program "welfare for the rich," and there is justification for that point of view. The next table displays actual net income per farm operator for 1984 (including off-farm income and government payments per operator) and the percent of net income made up of direct government payments:

TABLE V.9.—NET INCOME AND GOVERNMENT PAYMENTS

Sales class	Net income per operator	Payment per farm	Percent of net income
$500,000 plus	$440,806	$33,677	7.64
$250,000 to $499,999	93,312	20,558	22.03
$100,000 to $249,999	42,655	13,031	30.55
$40,000 to $999,000	15,790	5,309	33.62
$20,000 to $39,999	21,482	2,198	10.23
$10,000 to $19,999	16,271	866	5.32
$5,000 to $9,999	18,608	338	1.81
$2,500 to $4,999	17,218	116	.68
Less than $2,500	19,253	56	.29
Total	28,658	3,621	12.62

The most striking feature of this tabulation is that those with the highest net income—exceeding $400,000 annually—are also the recipients of the highest payments from the government! Nevertheless, government payments account for less than 10 percent of the net income of this group. For those with farm sales ranging from $40,000 to $250,000, however, the smaller payments received constitute a much higher proportion—about one-third—of net income.

The contrast between the amount of assistance given to large farms versus small farms is even more dramatic when both direct and indirect government farm program assistance over a period of years are considered. Indirect aid includes "nonrecourse" commodity loans, which need not be paid back when the market price is below the loan level, and purchases of surplus dairy products. Unlike direct assistance payments, there is no "cap" or maximum amount of assistance any single producer can receive under these programs, and the benefits are therefore basically distributed in direct proportion to sales or production. The following table shows average total direct and indirect government aid to each operator by sales class in the five-year period 1980 through 1984:

TABLE V.10.—DIRECT AND INDIRECT GOVERNMENT FARM AID PER OPERATOR, 1980–84

Sales class	Indirect aid per farm	Direct aid per farm	Total per farm
$500,000 plus	$226,881	$110,945	$337,826
$250,000 to $499,999	49,216	57,589	106,806
$100,000 to $249,999	22,476	38,692	61,167
$40,000 to $99,999	9,979	16,714	26,693
$20,000 to $39,999	4,487	6,762	11,249
$10,000 to $19,999	2,301	2,886	5,187
$5,000 to $9,999	1,197	1,437	2,634
$2,500 to $4,999	593	634	1,227
Less than $2,500	214	375	589
Average	8,500	20,182	18,683

For those farm operators who are unable to generate a profit from farming operations, both off-farm income and government aid may be used to supplement sales receipts. The following table shows total off-farm income and government aid resources available to each sales class in 1984, as well as the average per operator:

TABLE V.11.—OFF-FARM INCOME AND GOVERNMENT AID RESOURCES, 1984

Sales class	Off-farm aid (millions)	Government payments (millions)	Total per class (millions)	Average per operator
$500,000 plus	$451	$1,257	$1,708	$55,097
$250,000 to $499,999	883	1,712	2,595	33,701
$100,000 to $249,999	2,453	3,138	5,591	24,415
$40,000 to $99,999	3,431	1,996	5,427	15,374
$20,000 to $39,999	5,209	585	5,794	23,457
$10,000 to $19,999	4,773	299	5,028	18,691
$5,000 to $9,999	6,326	19	6,445	20,525
$2,500 to $4,999	5,348	8	5,386	19,585
Less than $2,500	11,139	34	11,173	20,962
Total	40,013	9,134	49,147	21,111

Those with the smallest amount of off-farm and government payment resources to help sustain their farming operations are those with farm sales ranging from $40,000 to $100,000. While the lower sales categories receive less in government payments, the deficit is more than offset by higher off-farm income.

In addition to gross and net income resources available to farm operators, another measure of need for government assistance which might be considered is the debt-to-equity ratio. Such information is presented in USDA's publication *Financial Characteristics of U.S. Farms,* January 1985. The following table, compiled from that source, shows the number and percentage of farms in each sales category with high debt-to-equity ratios:

TABLE V.12.—NUMBER AND PERCENT OF FARMS WITH HIGH DEBT

Sales class	Ratio over 100 percent		Ratio 70–100 percent	
	Number	Percent	Number	Percent
$500,000 plus	1,827	6.02	2,611	8.60
$250,000 to $499,999	3,993	5.82	6,118	8.92
$100,000 to $249,999	10,391	4.53	17,583	7.67
$40,000 to $99,999	13,982	4.57	18,540	6.06
$20,000 to $39,999	8,011	4.04	8,328	4.20
$10,000 to $19,999	5,820	3.01	6,581	3.41
Under $10,000	6,185	.96	12,069	1.88
Total	50,209	3.01	71,830	4.30

In addition to the raw numbers and percentages of farms in financial difficulty, a further useful measure of the scope of the problem is the value of assets under such stress. The following table shows the total value of assets owned in each sales category by those with high debt-to-equity ratios:

TABLE V.13.—VALUE OF ASSETS UNDER STRESS

Sales class	Assets (thousands)			
	Debt over 100 percent	Total	Debt over 70 percent	Total
	Per farm		Per farm	
$500,000 plus	$1,516	$2,770,468	$1,485	$6,591,748
$250,000 to $499,999	412	1,644,234	686	6,938,077
$100,000 to $249,999	251	2,607,653	428	11,961,962
$40,000 to $99,999	144	2,007,955	236	7,684,916
$20,000 to $39,999	102	815,400	145	2,362,783
$10,000 to $19,999	86	503,081	155	1,922,291
Under $10,000	72	444,646	80	1,462,766
Total	215	10,793,436	319	38,924,544

While direct government payments are made without regard to the degree of financial stress being experienced by a farm operator, it is interesting to draw a rough comparison between the two. This table compares the value of highly stressed assets (owned by those with debt-to-equity ratios exceeding 100 percent) to direct government payments by sales class in 1984:

TABLE V.14.—PAYMENTS VS. STRESSED ASSETS

[In millions]

Sales class	Direct government payments	Stressed assets per class
$500,000 plus	$1,044	$2,770
$250,000 to $499,999	1,583	1,644
$100,000 to $249,999	2,984	2,608
$40,000 to $99,999	1,874	2,008
$20,000 to $39,999	543	815
$10,000 to $19,999	233	503
Less than $10,000	168	445
Total	8,429	10,793

TABLE V.14.—PAYMENTS VS. STRESSED ASSETS—Continued

[In millions]

Sales class	Direct government payments	Stressed assets per class
Total over $100,000	5,611	7,022
Total under $100,000	2,818	3,771

It is notable that direct government payments in 1984 alone were of sufficient magnitude, if they had to be so used, to completely liquidate all of the debt against most of the insolvent operations. Moreover, direct payments to those operators with sales in excess of $100,000—approximately 85 percent of whom are not in high debt circumstances—totalled more than enough in 1984 alone to buy out all of the assets owned by insolvent operators with sales of less than $100,000. This is not to say that is what will happen, but it is most curious that a program ostensibly designed to help preserve the family farm system may in actuality be serving so perniciously to speed the demise of the smaller operators and, with them, the communities they support.

Regardless of the cause, it is a fact of rural life that a great many farms have been lost and, with their loss, the viability of rural communities has inevitably declined. The following table shows the distribution of the change in numbers and percentages of farms by sales class since 1969, when USDA began keeping statistics under the current sales categories:

TABLE V.15.—NUMBER OF FARMS AND PERCENT CHANGE

Sales class	1969	1984	Percentage change
$500,000 plus	4,000	31,000	+675
$250,000 to $499,000	11	77	+600
$100,000 to $249,000	32	229	+616
$40,000 to $99,000	155	353	+128
$20,000 to $39,000	304	247	−19
$10,000 to $19,999	369	269	−27
$5,000 to $9,999	381	314	−18
$2,500 to $4,999	368	275	−25
Less than $2,500	1,376,000	533,000	−61
Total	3,000,000	2,238,000	−22
Total over $40,000	202,000	690,000	+241
Total under $40,000	2,798,000	1,638,000	−41

Obviously, the contrast between the growth of big farms and the loss of small farms is stark. Tremendous aggregation of the industry into fewer and fewer hands has occurred. Adjustment of the sales classes to account for inflation would diminish to some extent the real growth of the larger farms, but it would not alter the relative loss of small farms to the larger operators.

The next table demonstrates the relative changes in the percentage of farms and percentage of net income by sales category from 1969 and 1984:

TABLE V.16.—PERCENTAGE OF FARMS AND NET INCOME (1969 VERSUS 1984)

Sales class	Percentage of—			
	Farms		Net income	
	1969	1984	1969	1984
$500,000 plus	0.1	1.3	16.2	49.5
$250,000 to $499,999	.4	3.3	7.0	23.6
$100,000 to $249,999	1.1	9.9	9.2	27.4
$40,000 to $99,999	5.2	15.2	23.0	8.0
$20,000 to $39,999	10.1	10.6	23.4	.4
$10,000 to $19,999	12.3	11.6	14.5	(1.5)
$5,000 to $9,999	12.7	13.5	6.8	(1.8)
$2,500 to $4,999	12.2	11.8	1.1	(2.3)
Less than $2,500	45.9	2.8	(1.2)	(3.3)
Total over $100,000	1.6	14.5	32.4	100.5
Total under $20,000	83.1	59.7	21.2	(8.9)
Total $20,000 to $100,000	15.3	25.8	46.4	8.4

In 1984 the largest 1.3 percent of farms accounted for almost half the net income to agriculture, and the largest 14.5 percent accounted for over 100 percent of net farm income. The percentage of those with sales of less than $20,000, which accounted for over eight of every 10 farms in 1969, fell but still remained at nearly 60 percent in 1984. Those in this group are netting losses, however, and are now largely farming as a hobby or for the purpose of sheltering off-farm income from taxation. For the $40-99,999 category, which grew from 5.2 percent of all farms in 1969 to 15.2 percent in 1984, the percentage of net farm income dropped by nearly two-thirds, from 23 percent to 8 percent. The $20-39,999 sales category remained steady at just over 10 percent of all farms but suffered a dramatic drop to almost no net income, and these farms too are in danger of becoming little more than tax-loss/hobby operations.

While farms in the latter two categories, with sales ranging from $20,000 to $100,000, account for only about one-fourth of all farms, they constitute nearly two-thirds of all commercial farms after those with sales of less than $20,000 annually are excluded. Thus, it would appear this is the group on which rural communities must depend, to the extent that such communities will continue to be viable at all, and it would seem that this is the group toward which the bulk of government assistance efforts should be directed.

The final table shows the change in net income per farm operator by sales class from 1969 to 1984:

TABLE V.17.—CHANGE IN NET INCOME PER FARM OPERATOR BY SALES CLASS (1969 VERSUS 1984)

Sales class	Net per farm (current dollars)	
	1969	1984
$500,000 plus	$581,580	$426,403
$250,000 to $499,999	91,382	81,846
$100,000 to $249,999	41,285	31,952
$40,000 to $99,999	21,308	6,052
$20,000 to $39,999	11,053	432
$10,000 to $19,999	5,643	(1,498)
$5,000 to $9,999	2,563	(1,531)

TABLE V.17.—CHANGE IN NET INCOME PER FARM OPERATOR BY SALES CLASS (1969 VERSUS 1984)—Continued

Sales class	Net per farm (current dollars)	
	1969	1984
$2,500 to $4,999	429	(2,233)
Less than $2,500	(125)	(1,653)
Total	4,787	11,471
Total over $100,000	98,993	79,637
Total $20,000 to $100,000	14,516	3,739

The upper three sales categories each have net incomes well above the national median family income, while the lower four categories each have negative farm income. Again, it is in the two categories comprising annual sales of $20,000 to $100,000 where the loss of income is most dramatic and where the need for government aid is most justified.

In opposing passage of the 1985 farm bill in the House of Representatives, the Administration argued that only 17 cents of every dollar of Federal farm assistance has gone to those in the greatest financial need. Policymakers apparently have felt, however, that it is necessary to provide assistance to those with no demonstrated need so as to allow some measure of assistance to trickle down to those under financial strain. Experience has shown that is an expensive and ineffective policy at best. At worst, it has hastened the demise of the smaller operations in the long run as government has actually aided their take-over by larger operators.

Now—at a time when significant segments of the industry are suffering under a great burden of debt and others have little or net income to show for their efforts—would be the worst of all times to continue, much less to increase, as some have suggested, governmental efforts to provide income support to those who have no need for it. Better targeting of assistance is clearly required, not just to reduce needless spending, but just as importantly to eliminate unwitting complicity by the Federal Government in the demise of the family farm system and the rural communities for which it is the lifeblood.

The bottom line in agriculture, as with all businesses, is cashflow. Should expenses exceed revenues for any extended period of time the interest rate for borrowed capital remains high reflecting lender risk, the value of assets owned by the business decline, and the business is eventually liquidated. Economic policies which raise farm revenues and stabilize farm expenses will serve to broaden the economic recovery to encompass agriculture. On the revenue side the demand for agricultural exports can best be enhanced by policies which would reduce the value of the dollar. On the expense side, policies which would reduce interest rates and payments would be most helpful. In 1984, interest payments accounted for 15 percent of total farm production expenses compared to 8 percent 10 years ago. However, because interest rates reflect risk, it is essential that an improvement in revenues be demonstrated.

To the disappointment of many, the 1985 farm act made no change in the method by which direct government payments are distributed within agriculture. There remains no correlation between government assistance and financial need. The amount of the government check is in proportion to the size of the farm operation. As a result, the government payment distribution formula ignores, and thereby fails to address, the farm problem.

However, the Food Security Act of 1985 does contain a provision which allows the Secretary of Agriculture to offer farmers the option of choosing among a schedule of different target price levels, each with an associated acreage limitation—the more land set-aside, the higher the target price. This option was popularly termed the "target option program," or TOP.

The principle beauty of the TOP is twofold: (1) For the first time in the history of the farm program, each farmer will be given a choice and allowed to manage his own affairs while focusing his attention on the realities of the marketplace, and (2) needless expenditures of limited public funding will be minimized by eliminating payments to those who are able to earn very adequate income without public assistance.

TOP draws the essential linkage between the production behavior of an individual farmer and the reward he receives for appropriate response to market conditions. At the same time TOP facilitiates the efficient operation of all farms, since each farmer himself, rather than Uncle Sam, will be in control. No two farming operations are alike, and no single set of monolithic program requirements will be best for all farms.

TOP maximizes production of our Nation's lowest marginal unit cost commodities, thereby enhancing our export competitiveness and minimizing needless food price inflation. Production restraint will be appropriately focused upon those who need it in order to gain higher returns, and marketplace returns will be maximized to those not needing public assistance.

The needless expenditure of public funds will be reduced since the "compensatory" component of the current program will be reduced; that is, less money will be spent to offset reduced production and sales foregone by those who have no real need to cut back to gain higher prices. Moreover, the program can be made self-correcting by adjusting for market conditions and the amount of money budgeted by Congress for farm income support. Market conditions and the amount of funding budgeted by Congress will determine the price and production options which can be made available to farmers.

Finally, the success of any assistance program must be measured by the degree to which it actually delivers aid to those in need. TOP affords the opportunity for vast improvement over current programs in that regard. TOP targets limited public assistance dollars on those who self-identify their own need for aid. The result will be that far greater aid can be delivered to those who need it while the overall cost of the program is maintained or reduced.

Gramm-Rudman-Hollings presents another challenge to agriculture. The President's budget proposes a reduction in commodity price support programs of $140 million in FY 1987, $275 million in FY 1988, and $411 million in FY 1989. Most are anticipating that these cuts will be accommodated by an equal, across-the-board percentage reduction in all farmers' price support payments. That is, if a 10-percent cut is mandated, a farmer who was eligible for $40,000 in deficiency payments would receive $36,000. Another alternative, and one which needs to be explored by the Administration and the Congress, is to reduce the payment cap from $50,000 to a figure sufficiently low to absorb the mandated annual budget cuts.

Broadening the economic recovery to embrace agriculture has eluded policymakers for four years. And it is not due to the lack of government income support to agriculture—nearly $45 billion during the last five years. Rather, the ineffectiveness of farm policy to at least cushion the effects of the continuing recession on financially stressed farms has been inappropriate and archaic Federal policy tools. The 1985 farm act, as currently written, perpetuates the failure and requires amendment.

THE RURAL ECONOMY

Nowhere has the absence of economic recovery been more evident than in rural America. This prolonged period of recession began during the stagflation years of the late 1970's. Despite the grim prospects for growth in rural states reliant on natural resource and manufacturing industries, Washington decisionmakers still devote scant attention to these problems.

Ironically, ignoring rural America's contribution to the mainstream U.S. macroeconomy and failing to unleash its full potential result in diminished economic activity in other sectors of the economy as well. For example, it has been estimated that the recent decline in agricultural exports has diminished the gross national product by $40 billion. Another estimate suggests that GNP would have been some $65 billion higher last year if the agricultural sector had been prosperous.

Rural America is at an economic disadvantage. By many broad measures of performance, it is clear that many rural areas are untouched by the U.S. economic expansion which began over three years ago. The following table contrasts the economic condition of metropolitan and nonmetropolitan areas of the U.S.:

TABLE V.18.—SELECTED ECONOMIC INDICATORS

	Percent of total	
	Metropolitan	Nonmetropolitan
Population	76.0	24.0
Personal income	80.0	20.0
Persons over age 65	59.0	41.0
Incidence of poverty	62.0	38.0
Incidence of substandard housing	33.0	67.0
Federal housing assistance	80.0	20.0
Job creation since 1982 [1]	90.0	10.0
Federal employment and training assistance	87.0	13.0
Unemployment rate (percent)	7.2	9.2
Underemployment rate (percent) [2]	12.3	17.1

[1] Joint Economic Committee estimate.

[2] Those whose wages or hours are reduced involuntarily.

Sources: U.S. Bureau of the Census, U.S. Department of Labor.

This table demonstrates just how far rural America is lagging behind. Relative to their urban counterparts, rural residents have lower incomes ($21,000 versus $27,000 per households in 1984), have fewer job opportunities, have higher joblessness rates, and are more likely to be in poverty or to live in substandards housing. These conditions are cause for significant Federal assistance, yet rural areas receive a disproportionately small share of Federal programs. This disservice to rural America may in fact be a leading cause for its being at a disadvantage in the first place. Nonmetropolitan areas receive a mere fraction of employment and training assistance, housing assistance and community, and area and regional development assistance. The last major analysis of metro/nonmetro shares of Federal programs was conducted in 1980. At that time, the nonmetropolitan share of a broad range of programs for infrastructure, community and economic development, and housing was just 19.9 percent of the total. Leading authorities on rural programs believe that the rural portion has decreased since then.

Coincidentally, the rural economy has worsened, particularly in the Midwest, Great Plains, and Rocky Mountain regions. Since metro/nonmetro comparisons of economic indicators are not readily available, the Joint Economic Committee staff has compiled a proxy. Of the 50 states, 16 have a greater nonmetropolitan population than metropolitan. Data from these states was aggregated for comparison to national data. The following table shows a dramatic divergence from U.S. trends. Of the 10 states in the Nation with the lowest business formation rates, nine were among these rural states. Additionally, the three worst bankruptcy rates in the Nation were found in this group. Only one of these 16 rural states had personal income growth exceeding the national average. Perhaps most alarming, only one out of 26 new mobs created last year occurred in these rural states.

TABLE V.19.—ECONOMIC PERFORMANCE FOR STATES WITH MAJORITY POPULATIONS RESIDING IN NONMETROPOLITAN AREAS

[Ranked in decreasing rurality]

State	New business incorporations, percent change, Jan-Jun 85/Jan-Jun 84	Business failures, percent change Jan-Sep 85/Jan-Sep 84	Personal income percent change 3rd Qtr 85/3rd Qtr 84	Employment changes (thousand), Jun 85/Jun 84
Wyoming	0.9	8.4	3.4	1.1
South Dakota	-9.1	1.9	-2.0	-4.2
Idaho	-10.2	12.7	2.4	8.9
Vermont	-13.3	-31.1	5.9	6.1
Montana	-15.3	11.5	.2	-.3
Mississippi	4.2	10.8	.2	19.4
North Dakota	-20.8	-21.2	-1.9	-.9
Maine	9.5	-24.3	4.9	5.7
West Virginia	-9.5	-5.6	1.9	-9.8
Arkansas	8.1	53.7	4.1	9.7
Iowa	4.2	102.1	.5	-1.0
Alaska	-14.0	53.7	2.9	4.7
Kentucky	6.0	26.1	3.7	35.1
Nebraska	4.0	243.3	1.1	12.3
New Mexico	5.8	29.0	4.7	11.9

TABLE V.19.—ECONOMIC PERFORMANCE FOR STATES WITH MAJORITY POPULATIONS RESIDING IN NONMETROPOLITAN AREAS—Continued

[Ranked in decreasing rurality]

State	New business incorporations, percent change, Jan–Jun 85/Jan–Jun 84	Business failures, percent change Jan–Sep 85/Jan–Sep 84	Personal income percent change 3rd Qtr 85/3rd Qtr 84	Employment changes (thousand), Jun 85/Jun 84
Kansas	−13.8	109.0	2.9	21.9
Weighted average	−1.5	44.3	2.4	Total 120.6
U.S. average	2.8	6.8	5.0	Total 3156.0

Sources: U.S. Departments of Commerce and Labor, Small Business Administration

In the aggregate, personal income growth for these 16 states was just 2.4 percent—1.4 percentage points lower than inflation and less than half the growth rate for the whole United States. New business incorporations *fell* 1.5 percent compared to a 2.8 percent *rise* nationwide. Business bankruptcies skyrocketed 44.3 percent, over six times greater than the national figure. Employment growth has been dismal for these states as well. Five rural states experienced decreases in employment in the 12 months ending in June 1985. Gains in the other rural states were a mere 135,000, compared to the total U.S. employment gain of over three million for the same period.

Rural initiatives

One way to broaden the recovery would be to promote greater access to government procurement contracts. The 16 states listed above were awarded just 7.2 percent of the $176.5 billion in contracts in 1984. If Kansas was omitted due to its military contracts (principally aircaft), the other 15 states obtain about 5.9 percent of the total. Defense contracting in these rural states is even a lower share. In 1954, President Eisenhower called for rural employment opportunities in decentralized defense industries. Regrettably, just the opposite has occurred since. Including Kansas, just 6.2 percent of defense contracts are awarded in rural states. Without Kansas, the total for the other 15 rural states is just 4.5 percent. From most indications, taxpayers would benefit by greater utilization of these rural state's full participation in procurement. Wage scales and overhead costs tend to be lower in these states. In addition, worker productivity and dependability are higher. From a competitive viewpoint, these rural states are at a disadvantage only in terms of *access* to the bidding process; providing that access is a responsibility of the Federal Government that is not fully met and could receive greater emphasis.

The geographic distribution of Federal procurement contracts is demonstrable evidence of the lacking commitment of the Federal Government to rural America. Moreover, statistics and data collection on rural America is incomplete, and all too often inaccurate and impossible to compare to national or urban figures. While it is likely that the Federal Government can estimate what a typical urban family had for supper last night, it is equally likely that the government does *not* know if a rural family even *had* super. Excessive survey cost is the cited reason for the lack of rural data. But a few million dollars in extra outlays pales in comparison to the likely misallocation of billions of dollars in Federal programs.

Washington decisionmakers cannot institute appropriate policy without an accurate picture of what rural America is or what its needs are. Urban conceptions of rural America are frought with myths and misconstrued notions which only add to the problem. Indeed, if Federal policies intend to foster economic development, a renewed national commitment must occur, beginning with a fundamental awareness and education process. With a sound foundation, rural policy can be formulated and executed with confidence. The following recommendations address this issue:

Establish a national rural commission. To ensure that the Congress and Administration recognize the need for a revitalized rural economy, an appointed advisory task force could assess the agricultural and non-agricultural economies and social structure of rural America, analyze the effects of all Federal policies on rural America, determine the economic interdependence between rural and urban America, and recommend future rural policies.

Improve rural data collection. Primary responsibility lies with the Departments of Labor, Commerce, and Agriculture. However, all Federal agencies which gather data should be required to maintain appropriate rural/urban and metro/nonmetro data. A national rural data and research center could serve as a focus for gathering, analyzing, and disseminating rural information and for serving as a forum for rural policy issues.

Require "rural impact statements" on all Federal actions and proposals to assess how rural citizens are affected before policies are put in place. In addition, annual reviews of the progress made by all Federal agencies with rural programs could be mandated.

Restructure the Department of Agriculture by creating a "Rural Resources and Development Administration." Given the urban emphasis of the Department of Health and Human Services, Housing and Urban Development, and Labor in particular, it is apparent that the responsibility to protect rural interests in social and development programs rests with the Agriculture Department. Such and adminstration would reflect the growing diversity of the rural economy, provided comprehensive economic development and planning, promote social and political concerns, and enhance the visibility of rural America.

Independent of Federal policy action is another more important dimension to rural development—economic development planning at the local and state levels of government. The ability of any community to attract new industry and expand existing firms hinges on grassroots initiative. Clearly, communities have the most at stake in successful economic development. Local planners have the best knowledge of local human and physical resources, culture and unique features, and have the best idea of what kind of industry the locality wants to attract. Numerous Federal agencies and land grant colleges offer training and information in economic planning to facilitate local efforts.

Community colleges and vocational schools can be instrumental in demonstrating that communites can adapt to changing requirements of the workplace. Not only are they excellent in educating and retraining workers, but also the faculty and staff can serve as part of a locality's economic planning team. Several very successful programs in "school-based development enterprises" in which school training and activities are integrated into skills useful in the local and regional economy. Public and private four-year colleges and universities also can privide abundant and innovative resources to assist communities in economic development.

Most states have economic development agencies to assist communities in their efforts. State-level initiatives have shown tremendous creativity in addressing the needs of small business development, high technology adaptation, financial services and capital formation, and marketing expertise. Clearly, state government can form partnerships among local and county governments, educators and technicians, businesses, and individuals. Through cooperation and coordination, economic development efforts at all levels—Federal, State, and local—can broaden the reach of the current U.S. economic expansion to include rural America.

SUPPLEMENTAL VIEWS OF OLYMPIA J. SNOWE ON TRADE SECTION

I find that I am in disagreement with the recommendations in the Trade Agenda Section. As a result, I cannot add my name to the Republican views of the Annual Report of the Committee.

I believe the trade difficulties in the United States are staggering, and the result of our inattention to this major problem has lessened the confidence of American workers and the thousands of manufacturing and service industries affected by international trade. With particular respect to how our failed trade policies have denied an opportunity for fair trade to thousands of workers in Maine, I believe a real disservice has been done in our failure to respond to the trade difficulties affecting individual industries.

In Maine, literally thousands of shoe and textile workers have lost their jobs on account of sudden import surges, and the failure of the Administration to abide by U.S. trade laws to offer temporary relief in the case of the shoe industry, or to abide by the directives of the Multifiber Arrangement in the case of the textile industry, suggest lack of concern for what is happening to individual firms.

Maine's fishermen, lumber producers, and potato farmers have to wonder if their government cares about three traditional industries that are being absolutely crippled by subsidized imports from Canada. These industries have seen what happened to Maine's shoe industry, which saw 4,000 workers lose their jobs on account of the import situation last year alone. With the veto of legislation passed by the House and Senate in December to provide proper relief to the shoe and textile industries, what confidence can *any* industry have—in Maine or anywhere else—with our government's response to trade problems?

While dealing with the U.S. deficit is a difficult matter; frustration is running high throughout the country, and congressional sentiment on trade issues may be at a crossroads. The U.S. ran up an unprecedented $148.5 billion trade deficit in 1985. Certainly, the strong dollar adds importantly to the trade deficit. But while the United States is the largest and most open market in the world, the concept of free trade has increasingly become a myth as other countries have erected barries to our exports and given subsidized assistance to their exports. There is a clear sentiment running throughout the country—from Maine and across this country—that the U.S. must now take concrete action to pressure other countries to negotiate in good faith and to allow U.S. producers to compete fairly at home and abroad.

High trade and budget deficits pose a serious threat to our continued economic strength. While the Gramm-Rudman balanced budget legislation passed by Congress last December addresses the problems of high budget deficits, there remains no solution to decrease the growing volume of imports, which has caused the U.S. trade deficit to skyrocket.

As a result of free-trade oriented policies, the U.S. has opened up our domestic markets to imports, but the world market has not reciprocated this orientation. We cannot continue to allow the U.S. to be an international dumping ground for imports. In order to improve our trade situation, we must first defend our own industries which have suffered from misguided trade policies.

Further, it is premature to assume that major U.S. trading partners, such as Japan and Germany, will initiate new fiscal and monetary policies that will increase domestic demand. As we all know, past efforts by the U.S. to open the Japanese market to U.S. products have been largely futile. The unfortunate reality is that Japan, as well as our other trading partners, continue to protect their own industries from imports. The result is that U.S. exports have remained stagnant while imports of our trading partners have boomed.

However, current trade policies by the U.S. are only leading to the devastation of our own industries. We should stop allowing other countries to use the U.S. domestic market as a source of fueling for their own economic growth. In order to attain these goals, Congress must strengthen U.S. trade remedy laws to combat current policies by our trading partners which act only as a barrier to U.S. exports.

OLYMPIA J. SNOWE.

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